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Croatia: Growth Slowdown and Policy Alternatives

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and Policy Alternatives**

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Executive summary

Having reached a peak in 2002, Croatia's GDP growth lost momentum thereafter due to restrictive economic policy measures prompted by rising external and internal imbalances. The current account deficits, averaging 6-7% of the country's GDP over the past few years, were primarily the consequence of high and growing imbalances in commodity trade which could only be partly offset by earnings from services. Thus, these deficits had to be mainly financed by rising foreign debt, which has been identified as the main threat to macroeconomic stability. In 2004 Croatia, together with Latvia and Estonia, was the most indebted country as compared with the new EU member states and other Southeast European countries. At the beginning of 2005 the World Bank downgraded Croatia to a 'severely indebted middle-income country'.

In addition, Croatia has one of the largest public sectors if compared to the new EU member states or the EU-15, excepting Denmark, France and Sweden. As regards the expenditure structure, the public sector still spends a high portion on public sector wages and salaries, and on subsidies and transfers, as compared to the new EU member states. The high budgetary expenditures have been accompanied by relatively high fiscal deficits. This is especially true for the period following the crisis of the late 1990s. Since then, the reform of public spending has become one of the main economic policy issues. The aim is to bring the deficit gradually down to below 3% of GDP by the year 2007. Also, the government is determined to borrow in domestic rather than foreign currencies in order to diminish the risks associated with the exchange rate and interest rate movements.

Croatia's public debt has been on a steady increase in absolute and relative terms over the past couple of years. When compared to the new EU member states, only Hungary exhibits a higher portion than Croatia, while all other countries report much lower levels. Indeed, most of the new member states have managed to reduce their public debt levels over the past few years or to keep them stable.

The policy to deal with these macroeconomic imbalances adopted by the government and the central bank on the advice from the IMF in recent years is that of 'soft landing'. In sum, the adopted measures should slow down the growth of aggregate demand and thus lead to slower growth of imports and should stabilize the foreign debt to GDP ratio somewhere around 80% (in euro terms). This policy has brought mixed results so far and it is not clear whether continued reliance on it will be sufficient to move the economy to a path of sustainable growth rather than proving to be just a short-term deviation from the unsustainable growth path. Early in 2005, there were worries that policy is in fact overshooting with growth slowing down faster than expected or desired. Later in the year, growth has speeded up, but the current account deficit has also widened.

In any case, the policy adjustment measures that have been introduced will have to be supplemented with longer-term changes and eventually with structural reforms.

What are the policy alternatives? Croatia's macroeconomic stability is presumed on the stability of its exchange rate. A problem arises when the exchange rate looks like being misaligned, which is indicated by the unsustainable growth of foreign debt. In that case an adjustment of the exchange rate may be appropriate. If the exchange rate adjustment is not possible because of large balance sheet effects, the alternative would be a more aggressive wage policy. This, however, will largely depend on the assertiveness of the government, which is the main risk of this policy alternative.

Another possibility would be more supply-side policies, such as significant changes in the tax system. In a number of countries in transition the corporate tax has been decreased quite significantly. It turns out that a policy of low taxation does not cost the budget too much, because the revenues from the corporate income tax are small anyway, but do create an incentive for foreign investors to locate their operations in these tax havens. This is not a measure that by itself would turn the economy around, but could be considered as a supplement for the economic policy and structural reforms that are difficult to implement immediately. The idea would be to increase investments and growth and introduce structural and public sector reforms in a fast growing economy.

Keywords: *Croatia, foreign debt, fiscal deficits, economic policy*

JEL classification: *E6, F34, H50, H62, O57*

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Croatia: Growth Slowdown and Policy Alternatives

1 Macroeconomic developments[1]

1.1 Growth

Having reached a peak in 2002, Croatia's GDP growth lost momentum thereafter due to restrictive economic policy measures prompted by rising foreign debt and persistently high budget deficits. GDP growth slowed to 3.5% in the first half of 2005 and was accompanied by a deceleration of (public) investment growth to less than 2%. This weak performance in turn translated into a remarkable slowdown of construction activities, i.e. the completion of infrastructural projects, particularly the construction of motorways. Household consumption continued to grow at slightly over 3%, while government consumption stagnated in the first half of 2005 after five years of decline. The contribution of foreign trade to GDP growth turned again negative. In a comparative perspective, Croatia's GDP growth was lower than in Bulgaria and Romania, at the same level as in Hungary, and only higher than in Poland.

In order to illustrate the importance of changes in the individual GDP components for GDP growth, we use their contributions to the overall GDP growth rates. As can be seen from Table 1, over the past few of years that pattern has changed in Croatia. In the year 2000 consumption, investment and foreign trade all contributed positively to GDP growth. In the three following years it was only consumption and investment that drove GDP growth. At the same time the contribution of foreign trade turned negative. Between 2000 and 2004 the contribution of consumption was only related to private consumption, while the government contributed negatively to GDP growth over the whole period. The relatively strong expansion of private consumption was achieved at the expense of unfavourable changes in foreign trade. In 2004 the contribution of investment slowed markedly and foreign trade contributed positively to GDP growth for the first time since 2000. Increasing household consumption was made possible through rising wages but also as a consequence of high household lending.

A comparison with the new EU member states (NMS-5)[2] and Bulgaria and Romania shows that, though the sources of growth are rather uneven across the region, it was consumption that contributed significantly to overall GDP growth in all countries over the period 2000-2004. In a number of countries (the Czech Republic, Slovenia, Bulgaria and Romania) also gross fixed investment contributed steadily to GDP growth over the whole

[1] Research for this study was completed in November 2005.

[2] NMS-5: Czech Republic, Hungary, Poland, Slovakia and Slovenia.

Table 1

Contributions (percentage points) to GDP growth rates

	2000	2001	2002	2003	2004
Czech Republic					
GDP growth rate (%)	**3.9**	**2.6**	**1.5**	**3.7**	**4.0**
Consumption	1.6	2.2	2.5	3.6	0.6
Gross fixed investment	1.5	1.6	1.1	1.5	2.9
Trade Balance	-1.1	-2.2	-2.7	-1.5	-0.5
Hungary					
GDP growth rate (%)	**5.2**	**3.8**	**3.5**	**3.0**	**4.0**
Consumption	3.2	4.1	6.3	5.6	1.7
Gross fixed investment	1.9	1.2	2.0	0.9	-2.2
Trade Balance	0.5	2.1	-2.1	-2.6	0.8
Poland					
GDP growth rate (%)	**4.0**	**1.0**	**1.4**	**3.8**	**5.3**
Consumption	2.0	1.4	2.2	1.9	2.2
Gross fixed investment	0.7	-2.2	-1.3	-0.1	1.0
Trade Balance	1.2	2.9	0.7	1.8	1.1
Slovenia					
GDP growth rate (%)	**3.9**	**2.7**	**3.3**	**2.5**	**4.6**
Consumption	0.7	2.0	0.5	2.0	2.2
Gross fixed investment	0.2	1.2	0.9	1.8	2.0
Trade Balance	2.4	1.8	1.0	-2.4	-0.3
Slovak Republic					
GDP growth rate (%)	**2.0**	**3.8**	**4.6**	**4.5**	**5.5**
Consumption	-0.1	3.5	4.0	0.2	2.1
Gross fixed investment	-2.0	3.6	-0.2	-0.3	0.6
Trade Balance	1.9	-3.7	-0.1	6.5	-0.8
Bulgaria					
GDP growth rate (%)	**5.4**	**4.1**	**4.9**	**4.3**	**5.7**
Consumption	4.7	4.0	3.2	5.7	4.2
Gross fixed investment	2.6	4.3	1.9	3.1	3.0
Trade Balance	-3.3	-5.1	0.5	-7.1	-3.0
Romania					
GDP growth rate (%)	**2.1**	**5.7**	**5.0**	**4.9**	**8.3**
Consumption	1.2	5.6	2.3	6.0	8.9
Gross fixed investment	1.2	2.3	1.8	2.2	2.2
Trade Balance	-3.8	-5.2	0.6	-5.3	-3.1
Croatia					
GDP growth rate (%)	**2.9**	**4.4**	**5.2**	**4.3**	**3.8**
Consumption	2.1	1.1	4.1	2.5	2.3
Private	2.5	2.7	4.5	2.5	2.4
government	-0.4	-1.6	-0.4	-0.1	-0.1
Gross fixed investment	-0.9	1.5	2.7	4.0	1.2
Trade Balance	3.2	-1.4	-4.2	-1.5	0.5
exports of goods & serv.	5.1	3.7	0.6	4.6	2.6
imports of goods & serv.	-1.9	-5.1	-4.8	-6.2	-2.1

Source: Eurostat.

Table 2

Croatia: selected economic indicators

	2000	2001	2002	2003	2004 1)	2004	2005	2005	2006
						January-June		forecast	
Population, th pers., mid-year 2)	4437	4437	4443	4442	4439	.	.	.	.
Gross domestic product, HRK mn, nom.	152519	165640	179390	193067	207082	98276	104923	220800	234900
annual change in % (real)	2.9	4.4	5.2	4.3	3.8	4.0	3.5	3.5	3.8
GDP/capita (EUR at exchange rate)	4502	4998	5451	5747	6224	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	8080	8600	9260	9680	10290	.	.	.	.
Gross industrial production 3)									
annual change in % (real)	1.7	6.0	5.4	4.1	3.7	3.8	4.7	3.5	3
Gross agricultural production									
annual change in % (real)	-10.0	8.5	7.7	-15.9	11.9	.	.	.	.
Construction industry, hours worked 3)									
annual change in % (real)	-9.1	3.6	12.8	22.8	2.0	8.6	-6.0	.	.
Consumption of households, HRK mn, nom.	89637	98054	107427	113396	120312	59854	63945	.	.
annual change in % (real)	4.2	4.5	7.6	4.1	3.9	3.8	3.4	3	3
Gross fixed capital form., HRK mn, nom.	33281	36984	44114	53168	57141	28977	29961	.	.
annual change in % (real)	-3.8	7.1	12.0	16.8	4.4	8.2	1.9	2	4
LFS - employed persons, th, avg.	1553	1469	1528	1537	1563	1583	.	.	.
annual change in %	4.1	-5.4	4.0	0.6	1.7	2.9	.	.	.
Reg. employees in industry, th pers., avg.	291.9	287.2	281.0	282.6	281.7	281.5	276.0	.	.
annual change in %	-2.5	-1.6	-2.2	0.6	-0.3	-0.2	-2.0	.	.
LFS - unemployed persons, average	298.0	277.0	266.0	256.0	249.5	253.0	.	.	.
LFS - unemployment rate in %, average	16.1	15.9	14.8	14.3	13.8	13.8	.	13.5	13
Reg. unemployment rate in %, end of period	22.3	23.1	21.3	19.1	18.7	17.4	17.4	18	17.5
Average gross monthly wages, HRK	4869	5061	5366	5623	5985	5919	6179	.	.
annual change in % (real, net)	3.4	1.6	3.1	3.8	3.7	3.8	1.8	.	.
Consumer prices, % p.a. 4)	6.2	4.9	1.7	1.8	2.1	2.0	3.2	3	2.5
Producer prices in industry, % p.a.	9.7	3.6	-0.4	1.9	3.5	1.7	4.0	3.5	.
General governm.budget, IMF-def., % GDP									
Revenues	46.2	44.7	45.2	44.9	.	.	.	.	.
Expenditures	52.7	51.5	50.0	49.5	.	.	.	.	.
Deficit (-) / surplus (+), % GDP	-6.5	-6.8	-4.8	-6.3	-4.9	.	.	-4.2	.
Public debt in % of GDP	48.9	50.3	50.4	51.7	53.2	.	.	55	56
Discount rate % p.a., end of period	5.9	5.9	4.5	4.5	4.5	4.5	4.5	.	.
Current account, EUR mn	-489.9	-817.7	-2097.2	-1866.2	-1446.7	-2108.6	-2675.2	-1700	-1500
Current account in % of GDP	-2.5	-3.7	-8.7	-7.3	-5.2	-16.1	-18.9	-5.7	-4.8
Gross reserves of NB excl. gold, EUR mn	3783.2	5333.6	5651.3	6554.1	6436.2	6389.4	7065.7	.	.
Gross external debt, EUR mn	12109.3	13458.3	15054.8	19810.6	22675.4	21889.2	24206.8	.	.
FDI inflow, EUR mn	1142.1	1502.5	1195.1	1788.4	979.0	523.2	895.2	.	.
FDI outflow, EUR mn	1.5	175.6	597.8	93.0	280.9	60.0	77.9	.	.
Exports of goods, BOP, EUR mn	4969.3	5318.8	5293.1	5571.7	6603.1	3105.9	3401.2	7130	7560
annual growth rate in %	20.2	7.0	-0.5	5.3	18.5	13.2	9.5	8	6
Imports of goods, BOP, EUR mn	8468.6	9922.6	11253.5	12545.9	13330.9	6492.7	7016.0	14400	15260
annual growth rate in %	17.0	17.2	13.4	11.5	6.3	8.8	8.1	8	6
Exports of services, BOP, EUR mn	4442.0	5481.3	5832.3	7565.9	7636.7	2480.1	2441.6	.	.
annual growth rate in %	26.6	23.4	6.4	29.7	0.9	1.1	-1.6	.	.
Imports of services, BOP, EUR mn	1971.5	2178.5	2547.5	2632.8	2921.7	1285.7	1311.9	.	.
annual growth rate in %	0.3	10.5	16.9	3.3	11.0	9.8	2.0	.	.
Average exchange rate HRK/USD	8.28	8.34	7.86	6.70	6.04	6.13	5.78	.	.
Average exchange rate HRK/EUR (ECU)	7.63	7.47	7.41	7.56	7.50	7.53	7.43	7.4	7.5
Purchasing power parity HRK/USD, wiiw	3.74	3.80	3.85	3.89	3.93	.	.	.	.
Purchasing power parity HRK/EUR, wiiw	4.25	4.34	4.36	4.49	4.53	.	.	.	.

Notes: 1) Preliminary. - 2) From 2000 according to census March 2001. - 3) Enterprises with more than 20 employees. - 4) Up to 2001 retail prices.

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

period. Surprisingly, the contributions of foreign trade were characterized by remarkable swings across the individual countries. In the Czech Republic foreign trade contributed negatively to GDP growth from 2000 onwards, while Poland is the only country revealing positive contributions over the entire period. All other countries show a changing importance of foreign trade contributions from year to year. In 2004 foreign trade reduced real GDP growth in most new member countries and in the candidate countries, except for Hungary, Poland and Croatia – where it added to growth relatively little. In other words, GDP growth in all countries under consideration was driven by domestic demand everywhere in 2004 (for more details see Havlik, Podkaminer, Gligorov et al., 2005).

Following a deceleration over the past two years and a further slowdown in the initial months of 2005, industrial production growth gained ground from April, resulting in a 4.9% increase in the January-September period of 2005 (Table 2). This was mainly made possible through a remarkable output growth in manufacturing (6.6%) – with the food industry, publishing and printing, and the metal and wood industries contributing most to the favourable result. Labour-intensive industries such as textiles and manufacturing of wearing apparel, but also chemical industries all suffered severe output declines. Production growth in Croatia was among the highest compared to the NMS-5 where industrial output grew by 3.2% on average in the first seven months of 2005; among the Southeast European (SEE) countries only Bulgaria performed better than Croatia. Overall, industrial production is still far from its pre-transition level, reaching 77% in 2004 (latest available data) of what it had been in 1990. This compares well with the situation in most SEE countries, but is diverging significantly from the developments observed in the NMS-5 (Czech Republic, Hungary, Poland, Slovakia, Slovenia), where all countries but Slovenia had exceeded the pre-transition level by far.

1.2 Labour market

After severe employment losses from the early 1990s onwards, moderate job creation started only three to four years ago in Croatia. Depending on the respective data source, employment grew from 2001 or 2002 onwards, with the number of actual employed varying between 1.4 million (registration data) and 1.56 million (labour force survey, LFS) in 2004.[3] Unemployment fell to below 19% and 14% measured by registration and LFS data respectively in 2004. After a seasonal rise during the winter months, registered unemployment dropped again from March and totalled 294 thousand persons in September 2005, which is equivalent to a 17.2% unemployment rate (slightly less than in September 2004).

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3 Data obtained from the Croatian Pension Insurance Institute (CPII) point to an employment increase from 2001 onwards, with the number of employed totalling 1.46 million persons in 2004.

Compared with the NMS-5, Croatia and Poland exhibit the highest unemployment rates if measured by registration data. Based on labour force survey data, Croatia ranges among the medium-unemployment countries (Table 3). Structural indicators of unemployment show some improvement in 2004, but the situation remained worrisome in most cases. Youth unemployment is more than twice as high as both the average national rate and the EU-15 average and is exceeding the rates of most of the new member states, except Poland and Slovakia. The share of long-term unemployment fell significantly in 2004 and was lower than in Poland and Slovakia and in the two accession countries Bulgaria and Romania.

Table 3

Unemployment rates

according to LFS (annual average) and registration data (end of period)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Croatia										June
LFS	9.9	9.9	11.4	13.6	16.1	15.9	14.8	14.3	13.8	13.1
registered	15.9	17.6	18.1	20.4	22.3	23.1	21.3	19.1	18.7	17.4
Czech Republic										
LFS	3.9	4.8	6.5	8.7	8.8	8.1	7.3	7.8	8.3	8.1
registered	3.5	5.2	7.5	9.4	8.8	8.9	9.8	10.3	9.5	8.6
Hungary										
LFS	10.0	8.8	7.8	7.0	6.4	5.7	5.8	5.9	6.1	7.1
registered	11.2	10.9	9.5	9.3	8.6	8.0	8.0	8.3	9.2	8.9
Poland										
LFS	12.3	11.2	10.6	13.9	16.1	18.2	19.9	19.6	19.0	18.5
registered	13.2	10.3	10.4	13.1	15.1	17.5	18.0	20.0	19.1	18.0
Slovakia										
LFS	11.3	11.8	12.5	16.2	18.6	19.2	18.5	17.4	18.1	16.9
registered	12.8	12.5	15.6	19.2	17.9	18.6	17.5	15.6	13.1	11.1
Slovenia										
LFS	7.3	7.4	7.9	7.6	7.0	6.4	6.4	6.7	6.3	6.4
registered	14.4	14.8	14.6	13.0	12.0	11.8	11.3	11.0	10.4	9.8
Bulgaria										
LFS	14.1	14.4	14.1	15.7	16.9	19.7	17.8	13.7	12.0	10.6
registered	12.5	13.7	12.2	16.0	17.9	17.3	16.3	13.5	12.2	11.1
Romania										
LFS	6.7	6.0	6.3	6.8	7.1	6.6	8.4	7.0	7.5	.
registered	6.6	8.9	10.4	11.8	10.5	8.8	8.4	7.4	6.2	5.5
EU-15										
LFS	10.2	10	9.4	8.7	7.8	7.4	7.7	8.0	8.0	.

Note: 1) Preliminary.

Source: wiiw Database incorporating national statistics.

Table 4

Employment rates

employed in % of working-age population 15-64

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Croatia									
total	61.6	59.5	58.1	55.4	53.2	51.6	53.1	53.1	54.7
male	.	.	.	.	58.8	58.9	59.7	59.9	61.3
female	.	.	.	.	45.6	44.6	46.7	46.6	47.8
Czech Republic									
total	69.3	68.7	67.3	65.6	65.0	65.0	65.4	64.7	64.2
male	78.1	77.4	76.0	74.0	73.2	73.2	73.9	73.1	72.3
female	60.6	59.9	58.7	57.4	56.9	57.0	56.3	56.3	56.0
Hungary									
total	52.1	52.2	53.7	55.6	56.3	56.2	56.2	57.0	56.8
male	59.5	59.7	60.5	62.4	63.1	62.9	62.9	63.5	63.1
female	45.2	45.4	47.2	49.0	49.7	49.8	49.8	50.9	50.7
Poland									
total	.	58.9	59.0	57.6	55.0	53.4	51.5	51.2	51.7
male	65.2	66.8	66.5	64.2	61.2	59.2	56.9	56.5	57.2
female	51.8	51.3	51.7	51.2	48.9	47.7	46.2	46.0	46.2
Slovak Republic									
total	61.9	60.8	60.6	58.1	56.8	56.8	56.8	57.7	57.0
male	69.2	67.7	67.8	64.3	62.2	62.0	62.4	63.3	63.2
female	54.6	54.0	53.5	52.1	51.5	51.8	51.4	52.2	50.9
Slovenia									
total	61.6	62.6	62.9	62.2	62.8	63.8	63.4	62.6	65.3
male	66.0	67.0	67.2	66.5	67.2	68.6	68.2	67.4	70.0
female	57.1	58.0	58.6	57.7	58.4	58.8	58.6	57.6	60.5
Bulgaria									
total	54.0	54.1	53.7	51.2	50.4	49.7	50.6	52.5	54.2
male	57.7	58.0	57.5	55.1	54.7	52.7	53.7	56.0	57.9
female	50.4	50.3	49.9	47.5	46.3	46.8	47.5	49.0	50.6
Romania									
total	.	65.4	64.2	63.2	63.0	62.4	57.6	57.6	57.7
male	72.6	71.9	70.4	69.0	68.6	67.8	63.6	63.8	63.4
female	58.4	59.1	58.2	57.5	57.5	57.1	51.8	51.5	52.1
EU-15									
total	60.3	60.7	61.4	62.6	63.4	64.0	64.2	64.3	64.7
male	70.4	70.6	71.2	72.1	72.8	73.1	72.8	72.7	72.7
female	50.2	50.8	51.6	53.0	54.1	55.0	55.6	56.0	56.8

Source: Eurostat.

Overall, high GDP growth over the past several years was accompanied by just moderate employment growth or even stagnation. These tendencies are apparent in most of the new

EU member states and in the SEE countries as well (except Bulgaria where employment has been rising strongly since 2002). The relation between employment and production growth in the NMS has been disappointing, since even in the periods of robust GDP growth there has been little effect on the creation of new jobs. The employment elasticity has been much below unity (see Havlik, 2005).[4] Croatia's employment rate, at around 55% in 2004, is very low by EU standards and ranks at the lower end of the scale, only higher than in Poland and in Turkey and Bulgaria (Table 4). Regarding male rates, only Bulgaria and Poland range below Croatia, and in the case of female employment rates, Poland and Turkey exhibit lower values than Croatia.

Both average real gross and net wages continued to rise and were up by 4.2% and 3.7% respectively in 2004, implying that wage growth slightly exceeded productivity growth. However, in 2005 wage growth fell below productivity growth again.

1.3 Credits

In 2003 the share of household credits for the first time exceeded that of enterprises. In July 2005 households accounted for about half of the total credit volume, enterprises for 40%; the remainder was due to credits granted to local governments. Administrative measures imposed by the Croatian National Bank (CNB) to control credit growth led to a slowdown in household consumption but had no noticeable impact on enterprise borrowing.[5] In 2004 credits to the non-banking sector rose by 13.8%, of which by 18.7% to households and by 8% to enterprises – the latter figure being somewhat higher than in 2003. However, published figures for enterprises seem to be distorted and understate the availability of credits due to a strong increase in leasing and in enterprise direct foreign borrowing (Kraft and Jankov, 2005).[6] About HRK 4.5 billion or 44% of the newly granted private credits accounted for housing credits.

1.4 Foreign trade

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. The 2004 export outcome marked the best result since the country's independence.

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4 There are differences among countries: constant employment would require GDP growth of at least 3% in Hungary, more than 4% in the Czech Republic and about 6% in Poland.

5 *Inter alia*, at the beginning of 2003 the CNB introduced, as a temporary measure, the compulsory purchase of CNB bills if credit loans expanded at a quarterly (annual) rate higher than 4% (16%).

6 For instance, in 2003 enterprise lending increased by 5.1%, according to available statistics. But, including the above-mentioned forms of lending and some other 'balance sheet tricks', borrowing is estimated to have expanded by about 15%.

The turnaround in the (so far rather weak) foreign trade sector that had been hoped for after these results did however not materialize in 2005. In the first nine months of the year imports again rose faster than exports; as a consequence the foreign trade deficit was by some EUR 600 million higher than in the same period a year earlier. Trade with the European Union developed below average, whereas trade with the successor states of the former Yugoslavia, particularly Serbia and Montenegro, performed dynamically. Also exports to Slovenia saw a substantial upswing.

A breakdown by individual industrial branches shows a strong export expansion of food and beverages, fabricated metal products, and machinery and equipment. Export of ships, among the main export drivers in the past several years, dropped by 18% in the first three quarters of 2005. The import growth is first of all attributed to increased imports of petroleum and petroleum products and chemicals; below-average import growth from the EU was mainly the result of declining purchases from Austria and Italy. On the other hand imports from the Yugoslav successor states, Russia and Ukraine expanded substantially.

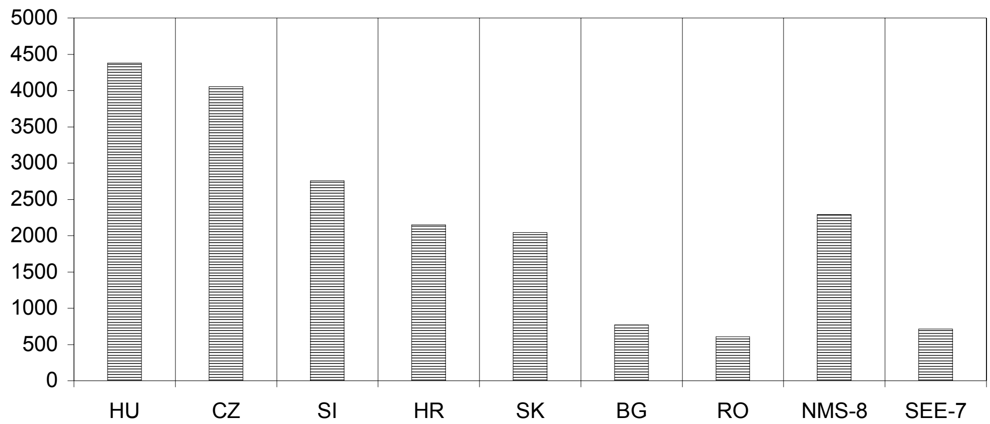
1.5 Foreign direct investment

After a slowdown in 2004 inward FDI gained momentum in 2005, owing to further investments in the banking and trade sectors. Greenfield investments, particularly in the export-oriented manufacturing sector, still play only a minor role in Croatia, accounting for less than 20% of the total FDI stock. However, when it comes to FDI per capita, Croatia ranks first among the South East European countries and it compares also well with the new EU member states. In 2004 Croatia ranked fifth after Hungary, Estonia, the Czech

Figure 1

FDI per capita, 2004

EUR



Source: wiiw Database incorporating national statistics.

Republic and Slovenia – even ahead of Slovakia and Poland (Figure 1). Outward FDI, totalling USD 1.7 billion between 1993 and the first half of 2005, is directed first of all to the top three destinations Switzerland, Bosnia and Herzegovina and Serbia and Montenegro.

1.6 Current account

Large and persistent current account deficits, averaging 6% of the country's GDP over the past few years, were primarily the consequence of high and growing imbalances in commodity trade, which could only partly be offset by the surplus in services trade, particularly by earnings from tourism. The current account deficits were mainly financed by rising foreign debt, totalling EUR 24.2 billion or 81% of the expected GDP by July 2005 (for further discussion see chapter on policy issues and alternatives).

According to the Croatian National Bank, in 2005 the debt service amounted to even USD 4.2 billion, of which USD 3.5 billion in principal and close to USD 700 million in interest payments. Principal repayments are highest for banks (USD 1.4 billion) followed by enterprises (USD 1.2 billion) and finally the state. Croatia's debt service burden is projected at around USD 3 billion in the 2006-2008 period.

1.7 Fiscal balance

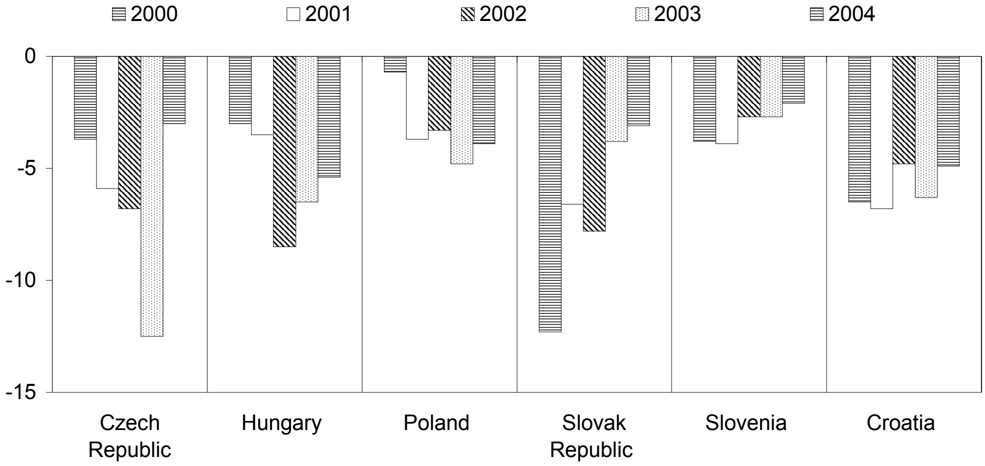
Reducing the fiscal deficit has been one of the primary tasks of the old and new Croatian governments. In 2003 alone the deficit of the consolidated general government budget amounted to 6.3% of GDP. Figures for 2004 put the general government deficit at HRK 10.2 billion or 4.9% relative to the GDP, which is slightly higher than the target rate set at 4.5%. This outcome compares well with most of the new member states (except the Baltic States and Slovenia), but is substantially higher than in the SEE countries, which have reached a remarkable fiscal adjustment over the past couple of years (see Figure 2).

The original budget bill passed by the Croatian parliament in November 2004 was aiming at a further reduction of the consolidated general government deficit to 3.7% in 2005, based on a projected 2.5% inflation rate and 4.4% GDP growth. As it became clear already in the initial months of 2005 that the targets were over-ambitious the government approved a supplementary budget in July, with the general government deficit revised upwards to 4.2% of the expected GDP. Most of the deficit is envisaged to be covered by domestic sources coupled with privatization receipts coming, *inter alia*, from the sale of the remaining

Figure 2

General government budget balance

% of GDP



Source: Eurostat and Ministry of Finance of Croatia.

state stakes in Croatian Telecom and at least 15% of the oil and gas company INA. In the agreement with the IMF from August 2004, the country's authorities had committed themselves to meeting at least one third of government borrowing requirements from the domestic market in 2004 and raise this share in the coming years (for a more detailed analysis of the fiscal sector see below).

1.8 Growth prospects

In 2005 GDP grew at about the same rate as a years earlier, whereas in 2006 a slight upswing is feasible. Growth will be supported primarily by domestic demand, though (public) investment growth is expected to moderate further compared to the robust growth over the last couple of years, particularly in construction investment. Thus, growth will have to be borne primarily by private sector activities. The situation on the labour market will change only gradually: employment will grow only moderately or even stagnate, whereas the number of unemployed will remain at high levels. Despite some rise in inflation in 2005, the National Bank will adhere to its policy of stable prices and exchange rates. The current account deficit will diminish only slightly over the coming years.

1.9 Integration

Following a positive report by Carla del Ponte, chief prosecutor of the ICTY (International Criminal Tribunal for the former Yugoslavia), accession talks with the EU were finally launched on 3 October 2005. Membership negotiations – originally scheduled to start on 17 March 2005 – had been put on hold as Croatia failed to fully cooperate with the ICTY in

The Hague, i.e. to locate and extradite the fugitive, suspected of war crimes, general Ante Gotovina. Assuming that negotiations will take about the same time as they did with Slovakia – which finished its membership talks in the shortest period of time in the latest enlargement round – Croatia may enter the Union by 2010 at the earliest.

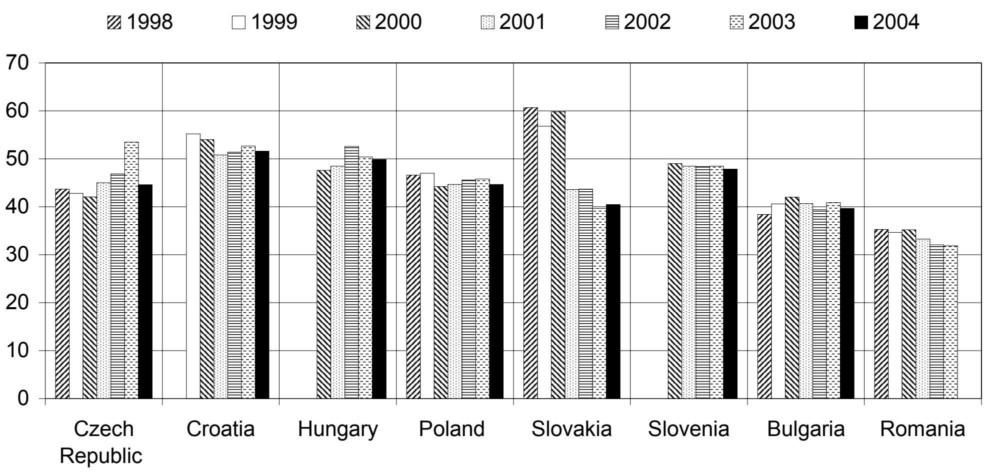
Accession talks with Croatia will be conducted in the framework of 35 chapters (not 31 as during the previous enlargement round) as some policy areas will be split. The Stabilization and Association Agreement (SAA) signed between the EU and Croatia in 2001 came into force on 1 February 2005. Croatia's first pre-accession programme was adopted by the government by the end of November 2004, 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.

2 Fiscal sector

Information on Croatia's fiscal sector is lacking transparency due to several methodological changes in the data compilation over recent years. To illustrate the problem, it is for example impossible to figure out the actual size of the public sector in Croatia since time series are inconsistent and/or incomplete: e.g., available 2004 data on the general government expenditures measured as a share of GDP vary between 49.5% and 51.6%; similar discrepancies are found for other years (for more details on data provided by different sources see Appendix). This makes an assessment of the actual situation difficult.

Figure 3

General government expenditures as a share of GDP, 1998-2004



Source: Eurostat, wiiw Database incorporating national statistics; Croatia: Ministry of Finance, IMF.

Irrespective of these differences, Croatia has one of the largest public sectors if compared to the new EU member states (among which Hungary comes next) or the EU-15, excepting Denmark, France and Sweden. Expenditures as a share of GDP are among the highest if compared to these countries (Figure 3).

When it comes to the expenditure structure, Croatia again shows a different picture as compared to the new EU member states (Table 5). The public sector still spends a high portion on public sector wages and salaries, and on subsidies and transfers, as compared to other countries (for more details on subsidies see below).

Table 5

General government revenues and expenditures as a share of GDP, 1998-2003

	Total revenue	Non-tax revenue	Tax revenue	Total expenditure	Current expend.	Wages & salaries	Goods & services	Subsidies and transfers	Capital expend.
Croatia	**46.6**	**4.0**	**42.4**	**52.5**	**45.3**	**11.8**	**11.3**	**20.1**	**6.5**
Hungary	43.3	4.6	38.8	47.6	43.0	11.3	7.1	19.9	4.5
Czech Republic	38.9	2.6	36.3	43.9	38.6	3.5	5.2	28.9	5.4
Poland	38.5	4.4	34.1	42.9	40.0	11.1	6.3	19.7	2.9
Slovakia	38.8	5.2	33.5	42.8	37.9	8.3	5.2	19.8	4.9
Slovenia	41.0	2.5	38.3	42.7	38.6	9.5	8.0	18.9	4.2
Macedonia	33.7	2.1	31.5	36.2	33.7	7.9	4.7	19.4	2.6
Bulgaria	37.0	7.9	29.1	34.1	30.2	4.5	7.0	15.5	4.0
Romania	30.3	1.9	28.5	34	30.5	5.0	7.5	14.4	3.2
Euro area	47.3	5.1	42.2	49.2	45.2	10.6	.	27.8	4.0

Source: IMF.

The most important category of general government expenditures is social benefits, the share of which accounted for 43.5% of total current spending in 2004, slightly more than a year earlier. Compensation of employees (including wages and salaries and social contributions) made up some 27%, or 23% if looking at public sector wages and salaries only – both values were about one percentage point lower than in 2003. The third most important item of expenditures is the use of goods and services (almost 10%, declining share). Categories revealing a growing importance in 2004 are current spending on interest, subsidies and other expenditures.

2.1 Government expenditures by function

Comparisons of the public expenditure composition show that similar to the new member states spending on social protection is the by far most important category of government expenditures in Croatia (Tables 6a and 6b).[7] Measured as a portion of GDP it compares well with Hungary and Slovenia, exceeds the values of the Czech Republic and Slovakia, but ranges below the EU-25 level.

Table 6a

General government budget: functional classification, 2003

in % of GDP

	HR 2001	EE	HU	SK	SI
Total expenditure	50.0	35.8	49.8	39.3	48.1
1. General public services	3.5	3.2	8.1	5.2	8.5
2. Defence affairs and services	2.3	1.8	1.3	1.8	1.4
3. Public order and safety affairs	2.5	2.7	2.0	2.0	2.0
4. Education affairs and services	4.2	6.4	6.0	4.4	5.9
5. Health affairs and services	6.8	4.1	5.6	2.3	6.8
6. Social security and welfare affairs and services	17.2	10.4	16.9	15.7	18.3
7. Housing and community amenity affairs and services	2.5	0.6	1.1	1.1	0.4
8. Recreational, cultural and religious affairs	1.1	2.2	2.2	1.0	0.9
9. Economic affairs	6.4	3.8	5.7	5.1	3.5
10. Environment	.	0.6	0.8	0.7	0.5
Expenditures not classified by major group	3.6				

Source: IMF, Eurostat.

Table 6b

Central government budget: functional classification, 2003

in % of GDP

	HR	EE	HU	SK
Total expenditure	41.0	27.5	34.5	25.8
1. General public services	1.8	3.4	7.4	4.3
2. Defence affairs and services	2.1	1.8	1.3	1.8
3. Public order and safety affairs	2.7	2.7	1.9	1.9
4. Education affairs and services	3.5	4.0	4.2	4.1
5. Health affairs and services	6.0	2.3	2.1	3
6. Social security and welfare affairs and services	17.3	8.9	7.1	4.4
7. Housing and community amenity affairs and services	1.1	0.0	0.4	0.5
8. Recreational, cultural and religious affairs	0.6	1.2	1.6	0.7
9. Economic affairs	3.2	2.9	5.1	4.7
10. Environment	.	0.4	0.3	0.4
Expenditures not classified by major group	2.6	.	.	.

Source: Ministry of Finance, Eurostat, own calculations.

7 The Ministry of Finance provides data on the functional classification only at the central government level; the data on the general government presented here are calculated by the IMF and do not exist on a regular base.

Another significant category is health, the portion of which is similar to that in the EU-25 but again higher than in the NMS, whereas government spending on education is generally lower. Croatia still spends a higher portion (though declining over time) on defence affairs and public order and safety than the EU-25 and the new member states. In 2003 that portion was close to 5%, while the respective values in the EU-25 and in Hungary were 3.4% each. Only Estonia reports a share similar to that of Croatia. Another important category relates to spending on economic affairs (6.4% of GDP)[8], which is much higher in Croatia than in the new EU member states, except the Czech Republic.

The high public expenditures have been accompanied by relatively high fiscal deficits, as can be seen from Figure 2 above. This is especially true after the crisis of the late 1990s. Since then, the reform of public spending has become one of the main economic policy issues.

2.2 State aid

Information on state aid granted by Croatia is incomplete since the state aid allocation system is not fully in operation yet. Provisional data indicate that the overall level of state aid was at 3.2% of GDP in 2003.[9] This was significantly higher than the 0.57% and 1.42% in the EU-15 and the NMS-10 respectively, in 2003 (European Commission, 2004 and 2005).[10] Though there were large disparities among the NMS – values ranged between 2.8% in the Czech Republic and 0.1% in Estonia – the reported level for Croatia was higher than in any other country.

By signing the Association Agreement with the EU, Croatia committed itself to harmonizing its state aid system in conformity with the *acquis*. This means 'starting a process of reducing the general level of state aid and shifting the emphasis from supporting individual enterprises or sectors towards tackling horizontal objectives of Community interest' (European Commission, 2005, p. 4).[11] In the case of Croatia, the share of horizontal aid was almost negligible over the past few years and accounted for 6.9% of total aid in 2003, which is extremely low compared to the EU-15, where the portion of horizontal aid

8 Economic affairs covers economic support programmes and subsidies to the mining, manufacturing, agricultural, energy, and service industries. It also includes public spending on infrastructure such as transport and communications.

9 Croatian figures on state aid are based on the 2004 Annual Report of the Croatian Competition Agency. In contrast to EU data, Croatian figures include aid on agriculture and transport, which consequently raises the aid to GDP ratio. Excluding these two items would reduce the state aid ratio from 3.2% to 1.4% in 2003 – still higher than the EU-15 average, but equalling the NMS average value.

10 EU-15 data refer to 2003, NMS-10 data refer to the annual average of the 2000-2003 period. If one excludes measures which are either being phased out under transitional agreements or limited in time, the portion of state aid in the NMS would drop to 0.67% of the GDP.

11 Horizontal aid is considered as being targeted to 'recognized market failures' and as being less distortive than sectoral and *ad hoc* aid. Considered as horizontal objectives are: research and development, safeguarding the environment, energy saving, support to SMEs, employment creation, the promotion of training and aid for regional development.

accounted for 79%. Compared to the NMS, where the respective share was 22% over the 2000-2003 period, the difference was much smaller. Croatian specific sector aid is, apart from transport (not an EU category), mainly directed towards shipbuilding[12], 'other sectors', tourism and financial services (the two latter are playing a much more important role in the NMS). In general, comparisons with the NMS are difficult as the state aid patterns reflect first of all the country-specific situation.

2.3 Public debt: general government debt

Croatia's public debt has been on a steady increase in absolute and relative terms over the past couple of years.[13] According to the Ministry of Finance, the general government debt (including government guarantees) rose to HRK 110.7 billion or 53% of the GDP by the end of December 2004. This represents an increase of about 1.7 percentage points compared to 2002. However, CNB data suggest a public debt increase to HRK 111.8 billion in December 2004 or 54.1% of the GDP. Both figures do not include pension arrears[14], an inclusion of which into public debt would significantly increase the debt to GDP indicator. Overall, fiscal developments over the past four to five years have shown two sources of additional debt accumulation: arrears (unpaid internal obligations of the public sector) and contingent liabilities in the form of stare guarantees (World Bank and IFC, 2004).

In contrast to previous years when foreign borrowing was the main component of general government debt, starting from 2004 domestic borrowing contributed most – two thirds – to the debt increase.[15] This new development brought about a substantial change in the composition of the general government debt stock, with the foreign share declining to 46% by the end of June 2005 from almost 56% by December 2002. If including government guarantees and the debt of the HBOR (Croatian Bank for Reconstruction and Development), foreign and domestic debt components were almost balanced in mid-2005.

The structure of central government debt, which comprises 84% of general government debt, has experienced a significant change in its foreign and domestic components. While

[12] In 2003 state aid for Croatian shipbuilding amounted to EUR 131 million versus EUR 685 million in the EU-15 as a whole (of which more than half accounted for Germany, followed by France and Denmark).

[13] Pursuant to the Croatian Budget Law, government debt is defined as the debt of the consolidated general government budget without guarantees. Government debt plus guarantees is defined as public debt.

[14] Pensioners' debt relates to a 1998 Constitutional Court ruling that the state was liable for unpaid pension indexation entitlements during 1993-1998. According to the Croatian authorities the debt is estimated at HRK 13.8 billion or 7% of the GDP in 2005. In July 2005 the parliament approved a scheme to repay this debt: each pensioner will be offered a choice between cash payments of half of the amount over 2006-2007, or full repayment over 2008-2013. These payments should be financed entirely through privatization receipts (see IMF, 2005).

[15] In 2003, out of the total debt increase 72% were made up of foreign borrowing, and the remainder by domestic borrowing.

up to 2003 the foreign debt portion was close to 60%, it diminished steadily thereafter and amounted to only 49% in June 2005, whereas the domestic share increased from 40% in 2003 to 56% in mid-2005. This turnaround reflects the commitment in the recent agreement with the IMF to 'reduce sharply the reliance on foreign borrowing' (IMF, 2004).

The central government accounted for almost the whole new general government borrowing in 2004 and for about two thirds in the first half of 2005, followed by extra-budgetary funds. Government borrowing was done almost exclusively on the domestic market in the first half of 2005, while its foreign debt share declined in relative and absolute terms as compared to the end of 2004.

The changing pattern of borrowing is also reflected when debt is measured as a share of GDP. By the end of 2004 the foreign portion of the central government debt stock was just one percentage point lower than in December 2003, but in the first half of 2005 it decreased significantly, to only 16.6% in June.

Irrespective of the definition, public debt is high when compared to the new EU member states. Only Hungary exhibits a higher portion than Croatia, while all other countries report much lower levels (Table 7). Indeed, most of the new member states have managed to reduce their public debt levels over the past few years or keep them stable. Bulgaria on the other hand had started from a very high level but came down significantly over the last few years (see also below).

A closer look at the central government debt figures reported by the Croatian National Bank shows that the 2004 debt stock was by HRK 11.9 billion higher than at the end of 2003, representing the most significant increase after 2000.[16] Nearly two thirds of the new debt was due to domestic borrowing, one third accounted for foreign borrowing. Within the domestic debt of the government, the debt of the funds was falling over the past two years, while there was a rapid expansion of the republic's debt. A breakdown by financial instrument shows that most of the domestic debt increase was due to the issuance of bonds, followed by treasury bills, while bank credits accounted for a negligible part only. The rise of the external government debt resulted exclusively from a debt increase in government funds through raising credits and issuing bonds, while the republic's debt was even slightly decreasing.

[16] In general, debt figures reported by the National Bank are higher than those of the Ministry of Finance as they include, in addition to the Republic's debt, also the debt of central government funds. Data published by the Ministry post the increase at close to HRK 10 billion.

Table 7

Gross external debt

in % of GDP, based on EUR

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Czech Republic	33.4	35.0	39.3	38.2	41.1	38.6	37.3	32.8	34.4	38.6
Estonia	.	32.8	53.1	50.7	54.8	54.4	55.5	60.1	68.7	81.2
Hungary	71.8	62.0	54.4	56.5	64.9	64.4	64.6	56.0	63.4	68.1
Latvia	31.7	37.8	45.6	44.7	56.0	61.2	69.0	70.2	76.5	89.2
Lithuania	.	29.8	33.9	32.4	44.3	42.4	44.3	39.8	41.0	42.9
Poland	39.0	31.2	33.0	33.7	42.2	41.4	39.3	40.0	45.7	48.2
Slovak Republic	30.3	37.9	51.7	51.4	54.7	53.1	53.7	49.2	50.6	52.6
Slovenia	29.5	32.9	35.3	34.4	39.6	45.2	47.1	48.4	53.5	58.8
Croatia	20.4	27.0	38.0	42.8	54.1	60.6	60.7	62.2	77.6	82.1
Albania	32.4	28.4	41.6	24.7	34.2	31.5	29.6	24.0	22.5	19.1
Bosnia and Herzegovina	.	.	.	.	41.7	40.4	40.3	36.8	32.7	29.6
Bulgaria	78.2	96.8	101.8	81.8	89.2	86.9	78.6	65.1	60.2	63.0
Macedonia	.	.	.	.	43.1	41.1	44.5	38.7	35.3	34.7
Romania	18.5	23.9	27.5	23.0	27.3	29.7	32.7	33.4	35.2	40.5
Serbia	.	.	.	.	.	49.4	105.8	71.1	64.5	57.3
Turkey	43.3	43.8	44.5	48.3	56.0	59.6	78.4	70.9	60.5	53.5

Note: For country-specific methodological notes see Table 1.

2.4 A comparative note on public debt

Comparing the development of public debt across the new EU member states and Croatia, some interesting observations can be made. Those are indirect in the case of Croatia because of the lack of comparable data.

In most NMS, the public debt to GDP ratio is either stagnant or falling, while it is rising in Croatia. Here some of the reasons for these diverging developments will be discussed. This discussion is based on the European Commission's 'General Government Data'. The methodology used to gauge the general government debt dynamics by the EU can be summarized by the following equation:

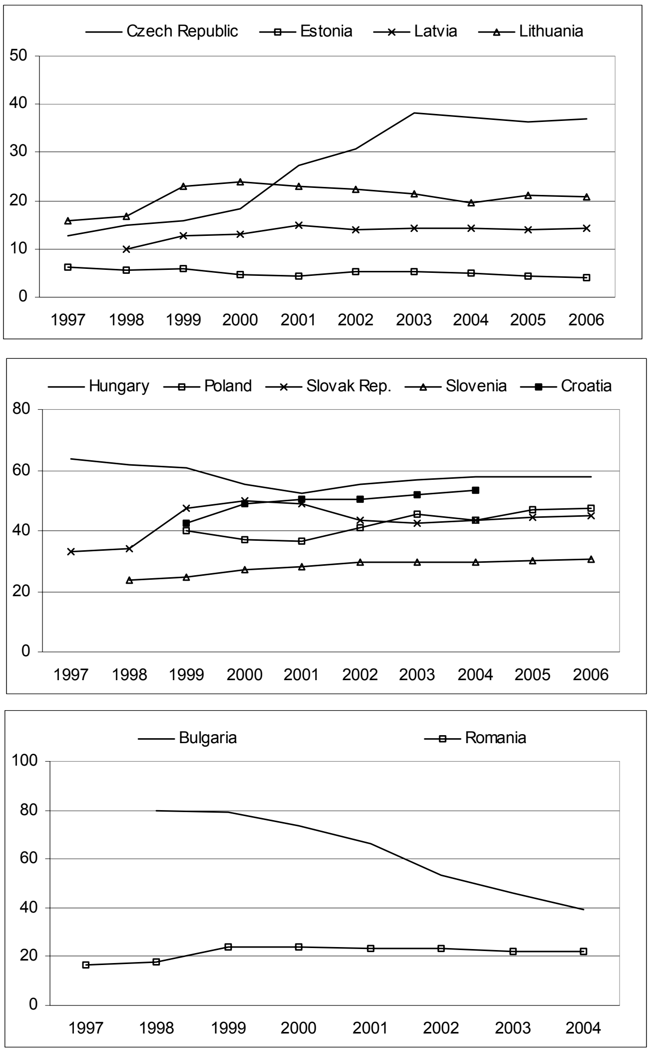
$$(D_t/Y_t)-(D_{t-1}/Y_t) = (PD_t/Y_t)+\{(D_{t-1}/Y_t)*[(i_t-y_t)/(1+y_t)]\}+SF_t$$

where Y is GDP at current prices, D is general government debt, PD is primary deficit, i is the implicit interest rate (actual interest paid divided by stock of debt), y is the nominal GDP growth rate, SF is the stock-flow adjustment and $_t$ stands for time. Therefore, the change in the debt to GDP ratio depends on the primary deficit, PD, on the so-called snowball effect,

$(D_{t-1}/Y_t)*[(i_t-y_t)/(1+y_t)]$, and on the stock-flow adjustment, SF. These three factors contribute to the increase or decline of the public debt to GDP ratio.

Figure 4

Public debt in % of GDP, comparison



Source: wiiw, AMECO, Ministry of Finance of Croatia.

One important observation is that the implicit interest rate, which is calculated as the ratio of paid interest to the stock of public debt in a particular year, is lower than the nominal growth rate in most NMS most of the time and particularly in the last several years. The same development can be observed in the case of Ireland and Spain and in a more ambiguous way in Portugal and Greece. In these latter cases, this relation between the interest and the growth rates is especially pronounced after the adoption of the euro.

It is not possible to directly compare the developments in Croatia with those in the NMS due to differences in data coverage and definitions. Still, some indirect comparisons may be indicative. Nominal growth rates are more or less in line with those in the NMS, but it is not known, at this moment in time, what implicit interest rate Croatia is paying. It is rather unlikely that it is above 8%, which is the average nominal growth rate in about the past four years. As the public debt is still rising, this means that the contribution of the other factors must be significant. The valuation effects may be significant, because of the high share of foreign debt in Croatia's public debt. Also, the contribution of the primary deficit has been significant.

The implication of this analysis is that the slowdown of growth together with the stable exchange rate, which both should imply a rather low inflation, may lead to a slowdown of nominal growth, and the main factor influencing the development of the public debt will have to be the primary deficit. In case that interest rates tend to be more equal to the growth rates, Croatia will have to run significant primary surpluses in order to stabilize its public debt to GDP ratio.

Finally, stock-flow or valuation effects have mainly contributed to the growth of debt. These effects are in some cases significant, especially for foreign debt. It stands to reason that these effects are important in Croatia too, given that, as will be mentioned below, there is a significant difference between the growth of foreign debt and the reported current account deficit. Whether these valuation effects are magnified because of the massive currency substitution in Croatia is an issue that is worth exploring further.[17]

3 Foreign debt

From a comparative perspective we can distinguish at least two groups of countries when analysing external debt developments: those which inherited a huge foreign debt and those with a low initial debt level.[18] Measuring external debt as a proportion of GDP (in euro terms), Croatia belongs to the latter group, with a ratio of about 20% in 1995 (Table 8).

Other comparatively low-indebted countries were the Baltic States but also the Czech Republic and Slovakia, Slovenia and Albania or Ukraine. By contrast, Hungary and Bulgaria were the most indebted countries at the beginning of transition. Up to the year 2004 this picture changed significantly. Bulgaria had managed to reduce its debt burden after the crisis in the late 1990s primarily through strong fiscal adjustments aimed at lowering public external debt. Actually this was achieved, among other things, through debt buybacks and the ongoing real appreciation of the lev, resulting in a fall of the debt ratio. However, the main contribution has come from the fiscal consolidation addressing both the

[17] For some analysis on the factors contributing to the development of the Croatian public debt see Babić et al. (2004).

[18] For further details see Gligorov (2004).

revenue and expenditure side (UNECE, 2003). On the other hand, private sector borrowing has been growing fast over recent years.

Table 8

Gross external debt in % of GDP (EUR)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Czech Republic	33.4	35.0	39.3	38.2	41.1	38.6	37.3	32.8	34.5	35.0
Hungary	71.8	62.0	54.4	56.5	64.9	64.4	64.6	56.0	63.5	64.1
Poland	39.0	31.2	33.0	33.7	42.2	41.4	39.3	40.0	45.3	47.7
Slovak Republic	30.3	37.9	51.7	51.4	54.7	53.1	53.7	49.2	50.6	48.9
Slovenia	29.5	33.4	35.8	34.7	40.0	45.8	47.4	48.8	54.1	59.2
Estonia	.	32.8	53.3	50.5	54.9	54.6	55.6	60.1	70.4	84.4
Latvia	.	37.8	45.6	44.7	56.0	59.9	69.1	70.3	76.6	90.7
Lithuania	.	29.8	33.9	32.4	44.3	42.4	44.3	39.8	41.0	42.8
Albania	32.4	28.4	41.6	24.7	34.2	31.5	28.5	22.0	20.6	.
Bosnia and Herzegovina	.	.	.	.	41.7	40.4	40.3	36.8	32.8	31.3
Bulgaria	78.2	96.8	101.8	81.8	89.3	88.0	79.3	65.1	60.7	63.3
Croatia	**20.4**	**27.0**	**38.0**	**42.8**	**53.2**	**59.4**	**57.8**	**62.2**	**77.6**	**82.1**
Macedonia	.	.	.	.	43.1	41.1	44.5	38.7	35.1	33.8
Romania [1)]	15.6	20.6	24.8	21.7	26.1	27.6	30.1	30.4	31.2	30.7
Serbia	.	.	.	.	.	50.2	105.8	71.2	65.1	57.5
Belarus	.	13.7	15.0	14.1	21.6	18.5	20.6	19.1	17.4	16.6
Russia	38.8	33.3	45.1	67.4	95.9	61.6	49.5	40.3	38.9	33.3
Ukraine [2)]	22.1	20.6	20.4	28.1	45.3	37.7	32.5	27.3	43.5	48.1
Turkey	43.3	43.8	44.5	48.3	56.0	59.6	78.4	71.3	61.2	.

Notes: 1) Medium- and long-term. - 2) Up to 2002 long-term debt only.

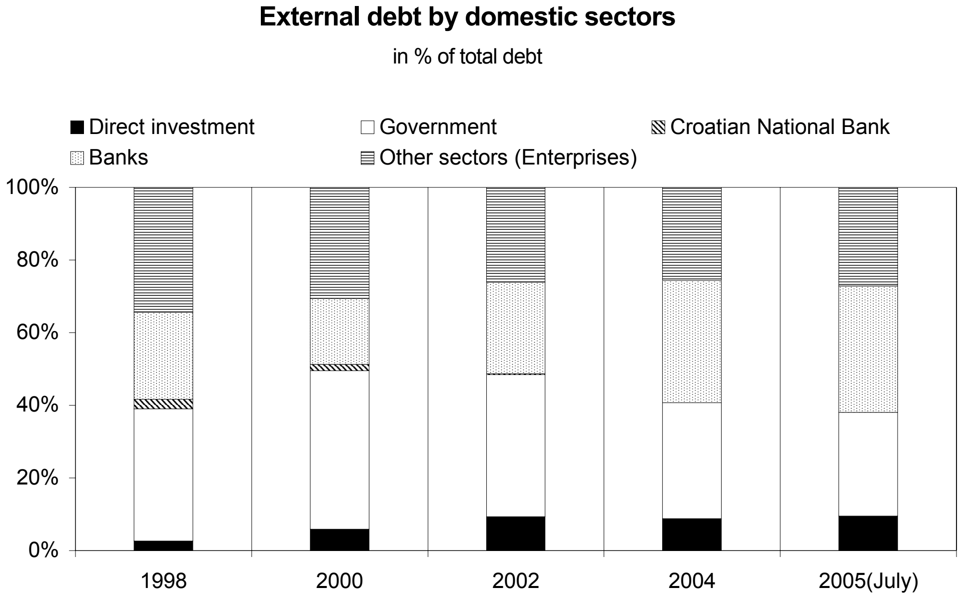
Source: wiiw.

Turkey, another example in the region and somewhere in between the two other groups, started from a relatively low level in 1995, reached a peak in the crisis year 2001 and recovered after a strong devaluation of the Turkish lira. Croatia, Estonia and Latvia are outstanding in that respect, all increasing their foreign debt levels over time. Only in 2001 was some improvement visible in Croatia, while in all other years the jumps were quite substantial. In 2004 Estonia, Latvia and Croatia showed the highest debt to GDP ratios.

3.1 Structure

An analysis of the Croatian debt stock by domestic debtors points to a high and growing portion of banks while the government's share fell from 40% in 2002 to about 29% in July 2005 (Figure 5). Banks, now the main debtors, account for close to 35% of the total external debt stock; the other sectors' (e.g. enterprises) portion increased to 27%. Finally, the share of foreign investment (inter-company lending)[19] rose from some 3% in 1998 to about 9.5% in July 2005.

Figure 5



Source: Croatian National Bank.

Overall, the share of public sector debt has decreased by 10 percentage points since the end of 2002. The maturity structure of foreign debt is satisfactory: by April 2005 (latest available data) about 86% of total debt was long-term (CNB, 2005, p. 44). A breakdown by domestic sectors suggests that most of the public debt is long-term (long-term credits and bonds), while for other sectors (enterprises) and foreign investments the share is about 90% and the banks' share of long-term debt is about 70%.

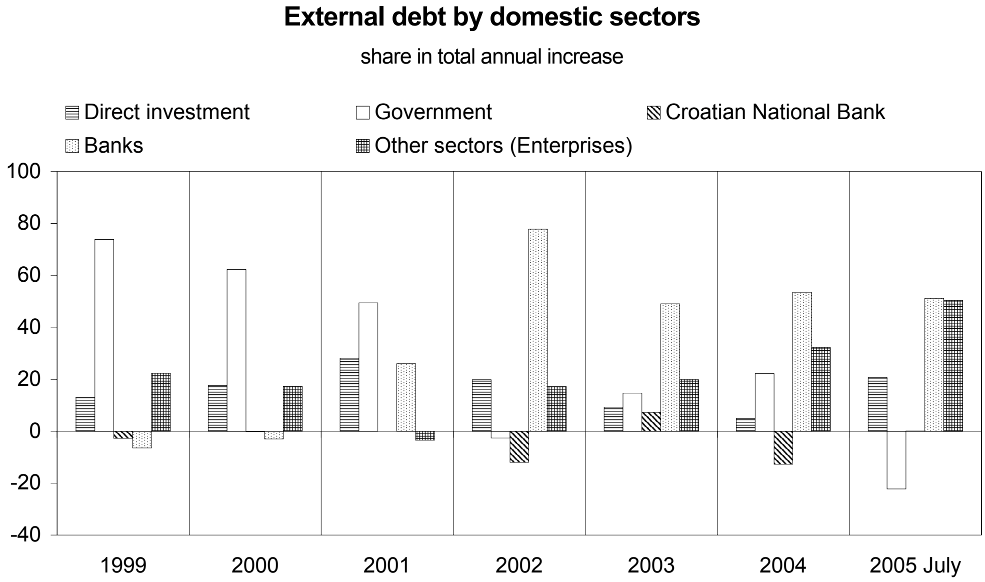
As far as the currency structure is concerned, by the end of April 2004 77.5% of total foreign debt was denominated in euro; dollar debt contributed 10.7% to the total, while Swiss franks and Japanese yen combined accounted for 8.2% and other currencies for 3.7%. By domestic sectors, banks' and enterprises' debt has a higher than average euro portion (84%) than that of the state (68%).

A closer look at the sources of new debt in Croatia shows a steep rise in bank lending; above-average increases were also registered in the enterprise sector in the past few years, while on the other hand government borrowing slowed down. Figure 6 shows that, until 2001, government borrowing accounted for up to two thirds of the total annual debt increase. Thereafter the banks became the prime borrower, but also the enterprise sector

[19] The exact CNB definition would be: 'borrower-lender transactions of other sectors that are interrelated by ownership (borrower or lender owns more than 10 percent of the other)'.

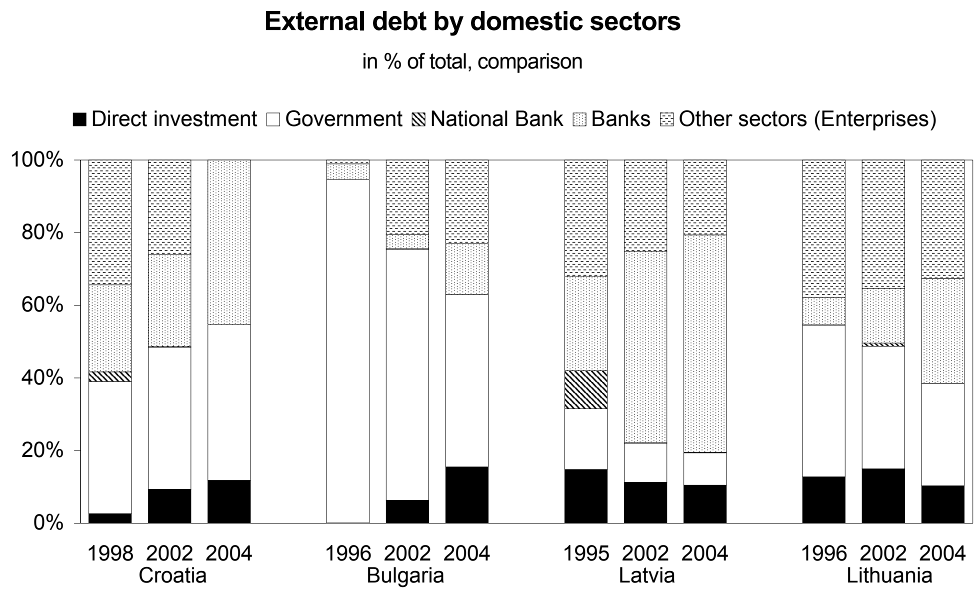
again increased its share in new borrowing – particularly long-term credits. During the first seven months of 2005 the government could even slightly diminish its foreign liabilities.

Figure 6



Source: Croatian National Bank, own calculations.

Figure 7



Source: National Bank of the respective countries.

Comparing Croatia with the Baltic States or Bulgaria we find that there are some distinctive features related to external debt:

- the expansion of external debt in Croatia in absolute terms is much higher than in any other comparable country;

- the share of government debt is almost negligible in the Baltic States and slowing in Bulgaria, whereas it is substantial (though declining) in Croatia;
- finally, the different exchange rate regimes may have influenced public actors' decisions in a different manner, while
- enterprise debt has increased rapidly in all countries.

3.2 Debt indicators

Available indicators on Croatia's foreign debt show an unclear picture. Some data suggest that the country is highly indebted, while others point to a moderate debt situation.

Based on the World Bank debt indicators,

- the debt to GDP ratio at close to 90% in USD terms (or 82% in EUR terms) points to a highly indebted country;
- in terms of debt to exports of goods and services (175%), Croatia's debt burden is moderate;
- the debt service to GDP ratio (24%) again points to a moderately indebted country, and
- the ratio of interest payments to exports of goods and services (4.2%) suggests even a low debt burden; however,
- debt to tax revenues is at a rather high level: it is over 250% if social contributions are excluded – a cut-off point for severe indebtedness – and it is around 200% if social contributions are included – which is still a rather high figure (see Table 9).

Table 9

Croatia: external debt in % of tax revenues

	1999	2000	2001	2002	2003	2004
External debt, EUR million	9937.2	11865.2	12827.6	15054.8	19810.6	22675.4
External debt to tax revenues, %	175.4	202.4	210.6	220.3	278.4	301.3
External debt to tax and soc. sec. contr. reven., %	119.6	139.3	143.0	153.6	192.9	197.8

Source: Ministry of Finance, Annual Report, 2004: Monthly Statistical Review.

The most recent report of the World Bank on Global Development Finance 2005 has downgraded Croatia to a 'severely indebted middle-income country' from a 'moderately indebted middle-income country' in the past couple of years.[20]

[20] The World Bank criterion for a country being 'severely indebted' is that either the debt to GDP ratio is above 80% or that the ratio of debt to exports of goods and services is above 220% – either one is sufficient.

Croatia's foreign debt continued to grow in 2004. Though growth slowed down as compared to the previous year, it was still about the average growth rate for the past ten years. In 2004 the debt to GDP ratio was some 8 percentage points higher than in 2003, which is about the average. Debt to exports of goods and services has in fact grown faster than on average, leading to a rather high ratio in dollar terms, around 175%. All other indicators are recording growth, though the speed is much more difficult to evaluate.

The trend growth of debt to GDP and to exports of goods and services, which are the two main indicators of indebtedness, has been considered unsustainable in the sense that it implies problems with the solvency of the Croatian economy. Given that there has been no clear break in the trend rate of growth of foreign debt, its development has to be assessed as being unsustainable still.

That does not mean that its growth is necessarily explosive in the sense that the debt to GDP ratio will grow for ever. In fact, if reported developments on the current account are considered, Croatia's debt to GDP ratio should stabilize at a sustainable level. Table 10 compares Croatia with the other Southeast European countries and shows that it does not belong to the group of those with current account deficits that are much too high for their growth rates.

However, there is a problem in the case of Croatia. It reports current account deficits that are way below its net new foreign debt. Thus, in 2004, new foreign debt was close to EUR 3 billion, while the current account deficit was below EUR 1.3 billion. There is a difference of close to EUR 2 billion. As reserves did not grow in that year, the difference has to be attributed either to an underestimation of the current account deficit or to capital flight or to valuation effects. In any case, if the rate of growth rather than the current account deficit is taken to assess the implied level of debt to GDP at which that rate will stabilize, it is well above 150%. It is hard to believe that this is the level foreign investors will feel at ease with.

Table 10

Sustainable foreign debt

	average annual euro nominal growth rate in % 2004/2000	current account in % of GDP 2000-2004	current account/GDP nom. growth rate GDP
Albania	13.1	-5.8	45 %
Bosnia and Herzegovina	6.6	-26.2	394 %
Bulgaria	9.3	-6.9	74 %
Croatia	8.5	-5.8	68 %
Macedonia	2.2	-5.8	260 %
Romania	9.1	-5.2	57 %
Serbia and Montenegro	9.2	-10.7	116 %

Figure 8a

Debt indicators, comparison 1998-2004

Debt to GDP ratio

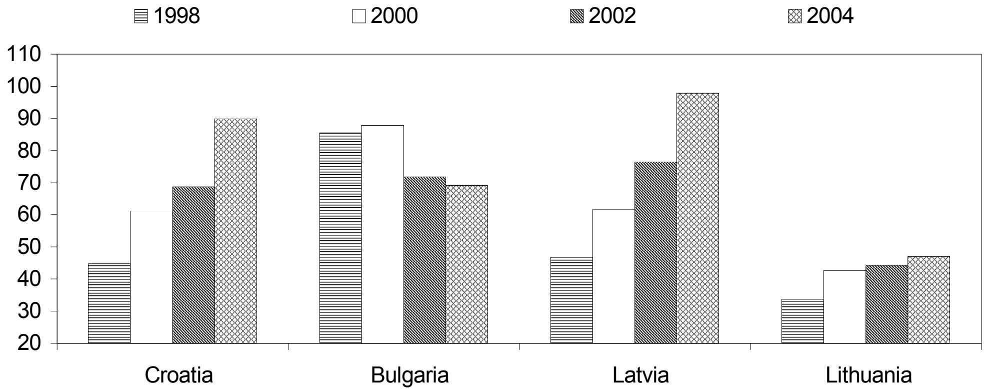


Figure 8b

Debt in % of goods and services exports

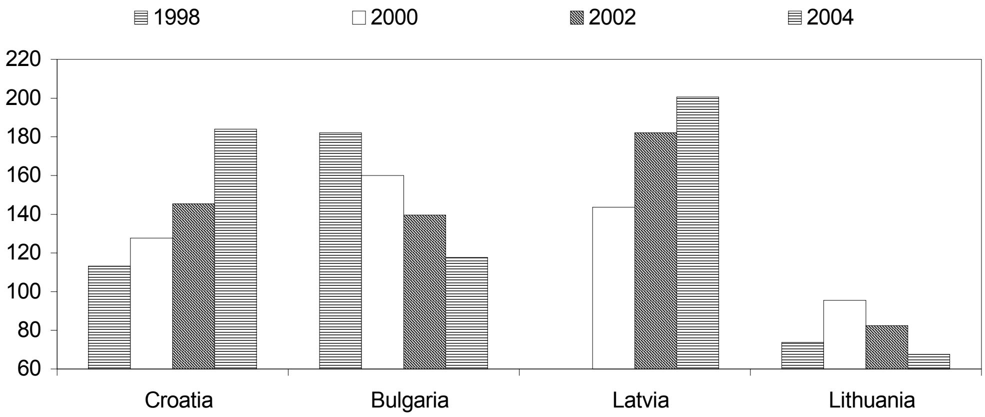
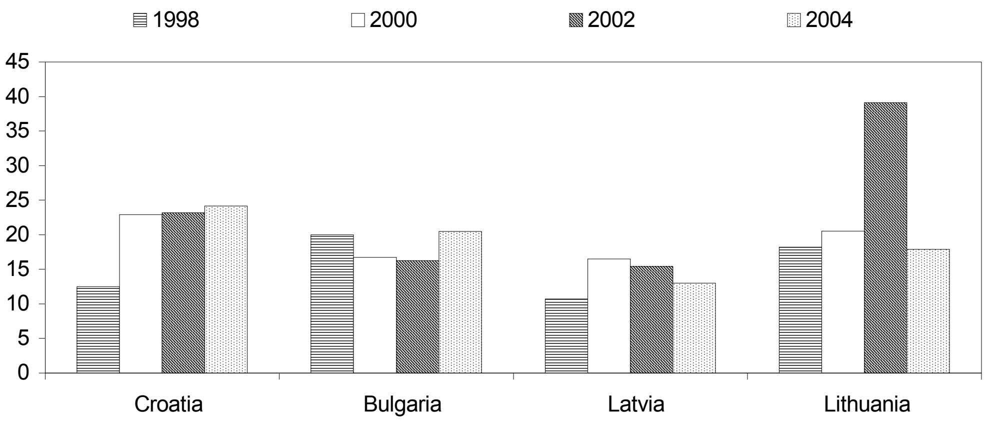


Figure 8c

Debt service in % of goods & services exports



Source: Transition Report update 2005 and wiiw.

Thus, there is no doubt that Croatia still faces the task of putting its external balances on the path of sustainability.

4 Policy issues and alternatives

4.1 Introduction

Croatia's economic policy has been facing two persistent problems: a high fiscal deficit and growing foreign debt. Both have been aggravating in the late 1990s when macroeconomic stability was threatened in the crisis that led to the collapse of the banking sector and to recession and was additionally sacrificed through increased public spending in the wake of the crucial elections in early 2000. Since then, the fiscal deficit has proved to be difficult to rein in, because that requires reforms in the structure of rights, while the foreign debt has continued to grow fast due to persistent trade and current account deficits. In 2003, both current account and fiscal deficits recorded quite high values, while foreign debt increased by a record amount. Those have somewhat stabilized since then, but at a very high level.

The policy to deal with these macroeconomic imbalances adopted by the government and the central bank on the advice from the IMF in the past couple of years is that of 'soft landing', which is certainly the appropriate one. The essence of it is the attempt to improve macroeconomic balances with a slowdown of growth. In 2004, that seems to have been achieved, though perhaps not to the extent originally intended. Early in 2005, there were worries that policy is in fact overshooting with growth slowing down faster than expected or desired. Later in the year, growth has speeded up, but the current account deficit has also widened.

This policy has brought mixed results so far and it is not clear whether continued reliance on it will be sufficient to move the economy to a path of sustainable growth rather than proving to be a short-term deviation from the unsustainable growth path. In any case, the policy adjustment measures that have been introduced will have to be supplemented with longer-term changes and eventually with structural reforms. In the brief discussion that follows, policy challenges will be highlighted, alternative policy mixes will be discussed and some basic policy issues will be commented on.

4.2 Current economic policy strategy

Since the stabilization in 1994, Croatia has had problems with its external balances and since 1999 with its fiscal balances too. The latter have been the consequence of the unreformed public sector and the strong presence of the political business cycle. The external imbalance has also been large mainly as a consequence of the high trade deficit. The surplus on the balance of services has not fully compensated for the trade deficit.

Lately, a deficit on the income balance has also developed. Thus, there is a persistent current account deficit. In addition, there is a large errors and omissions position in the balance of payments that is hard to account for.

The consequence of the persistent external imbalance is growing foreign debt, which has been identified, somewhat belatedly, as the main threat to macroeconomic stability. That has led to the adoption of a number of measures that should engineer a soft landing. In sum, these measures should slow down the growth of aggregate demand and thus lead to slower growth of imports and should stabilize the foreign debt to GDP ratio somewhere around 80% (in euro terms).

In addition, public expenditures should stop increasing and the fiscal deficit should start decreasing. The aim is to bring it gradually down to below 3% of GDP by the year 2007. Also, the government is determined to borrow in domestic rather than foreign currencies in order to diminish the risks associated with the exchange rate and interest rate movements. This should also increase the role of the domestic currency and diminish the rather high level of currency substitution. If indeed the domestic money market is developed, then the monetary policy will have more room to manoeuvre.

These demand-side measures are supposed to be helped by positive supply-side developments. Those are premised on the structural reforms that should include the speed-up of privatization, the reform of the labour market and, last but not least, a far-reaching reform of the public sector. Some of these reforms will be necessary anyway as they are part of Croatia's convergence and harmonization with the European Union. In the end, Croatia should be ready to join the EU and adopt the euro with a reformed public sector and a competitive market economy and with the fulfilment of the Maastricht criteria.

4.3 Policy challenges

The strategy of soft landing faces a number of challenges. If those prove insurmountable, alternative strategies should be considered. Here a number of problems will be discussed and then some alternative policies will be presented.

What about relative prices? If imports are to slow down, consumption has to slow down, and that means that growth should slow down too. This may not affect relative prices and especially the exchange rate. This is consistent with the view that a change in relative prices should come through a supply-side adjustment. The enterprise sector should cut costs, i.e., it should save on employment. Whether the labour market reforms will lead to more competition and thus to a lowering of wages and then to increased hiring is hard to tell. The answer will partly depend on the restructuring of the public sector because the most stubborn wages are to be found there. Clearly, all that will take time and it is questionable whether it implies a low growth rate over that whole period of time. If it does, that of course is an additional risk.

This is clearly the key issue. If public spending and private consumption are to be reduced, growth should be pushed by private investments and net exports. Some of these changes in the structure of aggregate demand are already taking place, as discussed at the beginning of this paper, but those may require appropriate changes in relative prices, because restrictive monetary and fiscal policies may not be enough.

What about public investments? Saving on public expenditures means primarily saving on investments because the other parts of public expenditures require reallocation of rights, which is of course a political issue. Croatia has indeed had an ambitious programme of public investments that will have to be scaled down – at least as long as a reform in the entitlements takes place. But pension reforms as well as reforms of the health and education sectors are usually not very popular and take some time to be put in place. There is no doubt that those are necessary, the issue is how feasible they are and whether public investments can and should be postponed for a prolonged period of time.

Is the policy mix appropriate? Currently, both monetary and fiscal policy should continue to be somewhat restrictive. Putting aside the question of feasibility, there is the issue of whether this is the appropriate policy mix. If interest rates are going to rise and the government is to borrow increasingly on domestic markets, that may lead to an acceleration of the growth of public debt. It may also lead to an appreciation of the kuna, as has in fact been the case in 2005. That may require a further saving on public expenditures. Again, this policy mix could work if public sector reforms are going to be implemented speedily and efficiently.

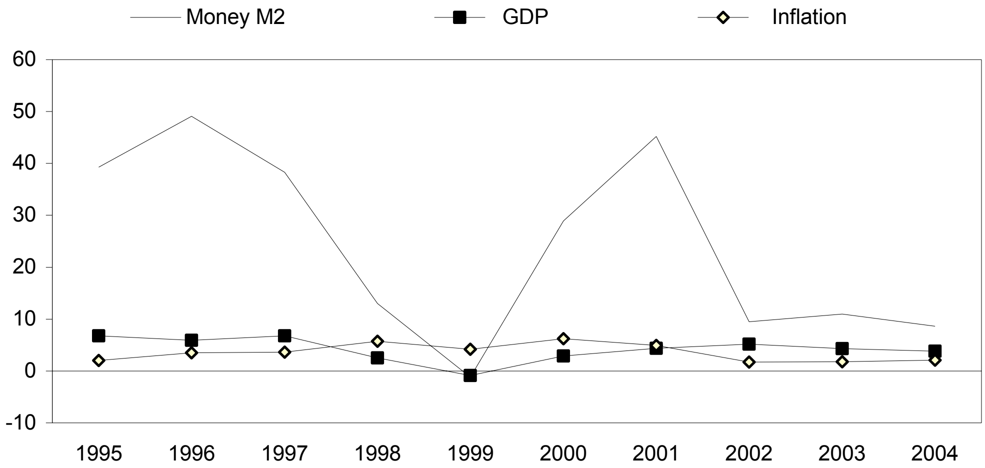
What is the influence of monetary policy? On the descriptive level, it does not seem to be very effective as can be seen from Figure 9. Large swings in money growth have not resulted in comparable corrections in inflation and growth. The effectiveness of the fiscal policy may be higher, but that essentially means reliance on changes in discretionary spending, i.e., in public investments.

As for the timing of structural reforms, a speed-up of privatization would be useful, but it is not clear whether this is indeed possible. It would be even better to attract greenfield foreign investments, but again it is not clear whether much can be done to attract them. Labour market reforms may prove to be useful, but increased flexibility may increase competition for the existing jobs while the creation of new jobs will depend more on the influence of the increased flexibility of wages. If wages prove to be sticky

Figure 9

Money M2, GDP and inflation, 1995-2004

real change in % against preceding year



Source: wiiw incorporating national statistics.

sticky downwards, then increased flexibility will not lead to much more investment and higher growth. Other structural reforms, for instance the use of competition policy, will take time even if they are pursued aggressively, which is not assured.

In general, it seems that the current economic policy is geared towards a short-term adjustment of public expenditures and some slowdown in imports, but the supply-side response is not targeted with changes in relative prices but more through structural reforms that may take a while to be devised and implemented.

4.4 Policy alternatives

Croatia’s macroeconomic stability is presumed on the stability of its exchange rate. That is not, in itself, wrong. A small, open economy with low credibility, both when it comes to its monetary and its fiscal policy, probably needs the exchange rate anchor. A problem arises when the exchange rate looks like being misaligned, which is indicated by the unsustainable growth of foreign debt. In that case, clinging to wrong relative prices may prove to be a very serious problem. If that is so, then an adjustment in the exchange rate may be appropriate. The issue really is not adjustment or no adjustment, but what policy of adjustment.

If foreign debt growth is unsustainable, that is the same as saying that there will be an involuntary exchange rate adjustment some time in the future. It may not be easy, of course, to determine whether the growth of foreign debt is not sustainable. But, if it is, then the exchange rate will have to give at one point in the future. In that case it is preferable that the adjustment to the new exchange rate level which is consistent with a sustainable growth of foreign debt takes place gradually and over a period of time. The end result is the same, but the costs are higher if there is an abrupt adjustment in the exchange rate.

That is then one policy alternative: to effect a change in relative prices via a depreciation of the real exchange rate. This is not a substitute either to fiscal adjustment or to the need for structural reforms. In fact, it should be seen as a complement to both. Its positive contribution should come through a slowdown of imports and a boost to exports. The effects on the various balance sheets should be taken into consideration. Those may not be an insurmountable obstacle, but have to be looked into carefully.

If the exchange rate adjustment is not possible because of large balance sheet effects, the alternative is a more aggressive wage policy. That is usually rather difficult to implement. The obstacles coming from the political economy are clear and have been recognized by most economists, starting with Milton Friedman. But there have been examples of such adjustments and thus that alternative cannot be altogether excluded. If, however, the government is not strong enough to introduce effective wage policies, then it will in all probability not be strong enough to introduce most other structural reforms either. That is the main risk of this policy alternative.

There is a possibility to have more active supply-side policies. Those would involve significant changes in the tax system. In a number of countries in transition the corporate tax has been decreased quite significantly. It turns out that a policy of low taxation does not cost the budget too much, because the revenues from the corporate income tax are small anyway, but do create an incentive for foreign investors to locate their operations in these tax havens. This is not a measure that by itself would turn the economy around, but could be considered as a supplement for the economic policy and structural reforms that are difficult to implement immediately. The idea would be to increase investments and growth and introduce structural and public sector reforms in a fast growing economy.

5 Conclusion

It is not certain that the current programme of adjustment will lead the Croatian economy to a path of sustainable growth. To the extent that it will rely on a slowdown of growth it may be just a short-term solution and the problems will reappear soon enough. Thus, measures should be considered to increase the competitiveness of the Croatian economy and maintain a high level of investment. Clearly, structural reforms are necessary, but policies that aim to support a more efficient structure of relative prices, particularly those that are determined through the exchange rate or wages or both, should be considered too.

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Appendix

Table A/1

Croatia: consolidated general government revenues and expenditures by different sources

in % of GDP

	1997	1998	1999	2000	2001	2002	2003	2004
MinFin Annual Report 2002/03								
Revenues and grants	.	.	53.0	48.9	47.6	46.2	46.6	.
Expenditures & net lending	.	.	55.2	54.0	50.8	48.8	49.5	.
MinFin (Statistical Review) own calc.								
Revenues and grants	.	.	.	.	.	46.3	46.4	46.5
Expenditures & net lending	.	.	.	.	.	48.3	49.7	49.5
IMF (August 2004, p. 45), GFS 1986								
Revenues and grants	.	51.1	48.4	46.2	44.0	44.5	44.3	.
Expenditures & net lending	.	54.6	56.6	52.7	50.7	49.6	50.6	.
IMF (September 2005, p. 19)								
Revenues and grants	.	.	.	.	44.0	46.3	46.4	46.6
Expenditures & net lending	.	.	.	.	50.7	51.4	52.7	51.6
Pre-accession programme, ESA								
Revenues and grants	.	.	.	.	.	.	46.4	47.7
Expenditures & net lending	.	.	.	.	.	.	50.8	51.1
World Bank 2003, Rep. 25434-HR, p. 11								
Revenues and grants	.	.	.	.	.	.	.	.
Expenditures & net lending	51.3	53.8	57.0	53.2	53.5	51.7	.	.
Croatian Economic Survey 7/2004								
Svaljek et al., pp. 76ff.								
Revenues and grants	47.6	50.8	48.1	46.5	45.2	44.8	44.7	.
Expenditures & net lending	49.8	52.4	54.9	53.7	50.6	49.9	49.7	.

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