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## **Croatia: Recession continues**

***In Croatia, GDP growth will decline again in 2012 and should finally rebound only in 2013, provided external demand and competitiveness strengthen. The poor situation on the labour market will continue to be a major obstacle to a recovery in household consumption. The burdens associated with high foreign debt servicing and reducing the budget deficit including structural reforms will remain the most serious challenges for the new government. EU accession in 2013 may stimulate foreign investment flows.***

Croatia's protracted economic downturn came to a preliminary halt in 2011, when GDP de facto stagnated. Gross fixed capital formation, on the decline since 2009, dropped by another 7%; both household consumption and government consumption, having decreased in 2010, showed a slight increase last year. In construction, where the output had shrunk from 2009 onwards, the negative tendencies continued with output down by 9%. Currently there is no evidence of recovery in the construction sector: there is a large number of unsold apartments on the market, investments both of the private and the corporate sectors are declining and a new cycle of infrastructure investments has not yet started. In industry production decreased for the third consecutive year and employment fell by another 3.7%. As a result of even more strongly declining employment, productivity in industry increased by 3%.

External trade lost momentum in 2011 with both exports of goods and services growing only slightly while imports contracted, particularly in services trade. The main reason behind the poor export performance was the decline in exports of the shipbuilding industry – the country's most important export sector. Owing to the reduction of the trade deficit the current account deficit continued to shrink and ended up balanced in 2011. As for FDI, net inflows were considerably higher than in 2010, but far below the levels achieved in the pre-crisis period. In 2011, FDI was directed primarily towards the financial sector, basic metals and real estate. At the end of 2011 the foreign debt stood at EUR 46.5 billion, i.e. about the same level as in December 2010. This corresponds to a debt to GDP ratio of slightly over 100%.

Maturing foreign currency obligations, low inflow of foreign funds and the weak export performance have all exerted a steady pressure on the Croatian currency in recent months; the exchange rate hit a seven-year low in January 2012. In response to the continued downward pressure on the kuna against the euro the Croatian National Bank intervened repeatedly on the foreign exchange market to support the domestic currency in 2011 and at the beginning of 2012. In addition the CNB raised the minimum reserve requirement for banks from 14% to 15% on 27 January 2012 (in September 2011 it had been raised from 13% to 14%). This measure should lead to the withdrawal of excess liquidity from banks, worth EUR 400 million, which is probably thought to stop the outflow of money (to the foreign mother banks). Željko Rohatinski, governor of the Croatian National Bank, emphasized that the CNB will adhere to its exchange rate policy and will be ready to further tighten liquidity rather than risking the depletion of its currency reserves. As regards joining the eurozone, the governor stated that Croatia should adopt the euro once it meets the criteria. The new Minister of Finance, Slavko Linić, is more cautious in this regard and admitted that joining the eurozone will take a long time. Croatian economists believe that the country could adopt the euro only at the end of this decade. Given the fragility of the Croatian economy it is questionable whether the EU/ECB will allow Croatia to join the EMU any time soon.

Croatia's labour market has been hit hard by the recession and it has not stabilized yet. Labour Force Survey data indicate that the number of employed fell by another 3.5% in 2011, which is by about 150 thousand persons less than in 2008. The unemployment rate stood at 13.7%, up from 8.4% in 2008. At the same time the activity rate and the employment rate fell by 3 and 5 percentage points respectively. Registered unemployment – traditionally higher than the LFS rate – stood at 18.7% in December, the same rate as a year earlier. Public spending on labour market policies was mainly concentrated on passive measures (unemployment benefits in particular) while spending on active labour market programmes was even cut because of fiscal constraints. The downward pressure on wages that has been felt since the outbreak of the crisis has continued in 2011; during the first quarter of the year real net wages fell by 0.3%.

In February 2012 the parliament adopted the budget for 2012 which is based on three principles: (i) commitment to the Fiscal Responsibility Act approved by the former government in order to gradually reduce the deficit and stabilize and/or cut public debt; (ii) creation of preconditions for starting economic growth; and (iii) protection of the most vulnerable groups of the society. The budget is based on the assumption of 0.8% GDP growth in 2012 and envisages the reduction of budgetary spending by HRK 4 billion (EUR 540 million) through cuts in expenditures on public sector employment (administration and

public enterprises), the reduction of subsidies for agriculture and Croatian Railways, lowering the support for citizens and households as well as the reduction of 'other expenditures'. Expenditures on pensions will increase by HRK 500 million and interest payments by HRK 1.2 billion (to HRK 9.5 billion). Revenues are envisaged to grow by 0.5% in 2012, however, most of the announced measures are either contributing to a reduction of revenues or will be neutral: for instance, revenue gains by raising the VAT rate from 23% to 25% (excluding VAT on baby food, oils, fats, and water bills, which will be cut to 10%) will be offset by lower revenues owing to the reduction of the health insurance rate from 15% to 13%.<sup>1</sup> The ceiling of non-taxable income will be raised from HRK 1800 to HRK 2200. Revenues up to HRK 2 billion should come from the privatization of the biggest local insurer Croatia Osiguranje, Postanska banka and state assets and holdings in private companies. Overall, the assumptions underlying the budget forecast seem to be too optimistic, since all recent forecasts provided by international organizations, banks and even the Croatian National Bank predict a GDP decline in 2012. Details on how to cut expenditures on the public sector wage bill are missing and unclear, but contrary to initial statements of politicians, layoffs can no longer be ruled out. According to the Minister of Finance, Croatia intends to raise about EUR 1.6 billion on international markets and about EUR 1.3 billion on the domestic market.

In November 2011 the Croatian National Bank withdrew the licence for the small Split-based Credo Bank because of inadequate capitalization and decided to 'closely watch' four other small banks. The action has fuelled fears in the public that the whole banking sector was in trouble. In September 2011 the ratio of non-performing loans to total loans increased to 12.2% from 11.2% in December 2010. Under the assumption that the economy will not recover in 2012 the Croatian National Bank estimates that the share of NPL may increase to 17% by the end of the year.

On 9 December 2011 the EU and Croatia signed the accession treaty; Croatia is expected to become a full member of the EU on 1 July 2013. In a referendum held on 22 January 2012, 66% of the Croatian electorate voted in favour of the country joining the EU. The voters' turnout was, however, very low at 43.6%. During 2012 the accession treaty needs to be ratified by the parliaments of all 27 current EU member states and by the European Parliament. Until accession, the EU will closely monitor the implementation of the commitments Croatia has to achieve – particularly in the areas of the judiciary, competition (shipyards) and freedom of movement – before the country can become an EU member.

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<sup>1</sup> The announced changes in the tax system are envisaged to increase the competitiveness of enterprises through the taxation of consumption and the reduction of labour costs.

At the parliamentary elections held on 4 December 2011, the centre-left 'Kukuriku' coalition consisting of four centre-left parties (Social Democrats, People's Party–Liberal Democrats, Istrian Democratic Assembly and Croatian Party of Pensioners) won 80 out of 151 seats in the Croatian parliament. The conservative Croatian Democratic Union (HDZ), ruling Croatia for 17 out of 20 years since the country's gaining independence, suffered the worst defeat in the party's history. The new government, headed by Zoran Milanović from the Social Democrats, took office on 23 December 2011.

Prospects for 2012 and 2013 are dampened by the poor economic outlook in the EU, which will have a negative effect not only on Croatia's exports of goods but also on services, tourism in particular. In addition, domestic demand will recover only slowly: household consumption will remain flat as a consequence of high unemployment and weak credit activity; investments will not recover any time soon. Thus, GDP will decline by about 1% in 2012 and rebound if at all only in 2013. Uncertainties emanating from the ailing western banking system – 90% of Croatian banking assets are in foreign (mostly Austrian and Italian) ownership – constitute a serious downward risk. Employment will continue to contract as the labour market will react with a time lag to production growth; the unemployment rate is expected to remain at around 14% in 2012 and 2013 and decrease only slowly thereafter. The current account deficit will remain within moderate limits. Major challenges for the new government are fiscal consolidation against the background of high unemployment and servicing foreign debt. EU accession in mid-2013 may stimulate foreign investment flows. Still, a number of challenges related to competitiveness remain, such as accelerating structural reforms, speeding up privatization and improving the investment climate.

Table HR

## Croatia: Selected Economic Indicators

	2006	2007	2008	2009	2010	2011 <sup>1)</sup>	2012	2013 Forecast	2014
Population, th pers., average	4440.0	4436.0	4434.5	4429.1	4417.8	4435	4435	4435	4435
Gross domestic product, HRK mn, nom.	291044	318308	345015	335189	334564	343300	347700	359600	374100
annual change in % (real)	4.9	5.1	2.2	-6.0	-1.2	0.3	-1.2	1	2
GDP/capita (EUR at exchange rate)	9000	9800	10800	10300	10400	10400	10500	10900	11300
GDP/capita (EUR at PPP - wiiw)	13700	15200	15900	14900	14900	15100	.	.	.
Consumption of households, HRK mn, nom.	168999	184979	197943	185651	186098	190800	.	.	.
annual change in % (real)	3.2	6.3	0.8	-8.5	-0.9	0.2	-0.2	0.5	1
Gross fixed capital form., HRK mn, nom.	75783	83514	95572	83386	72373	68900	.	.	.
annual change in % (real)	11.1	7.1	8.2	-11.8	-11.3	-7	-3	1.5	3
Gross industrial production <sup>2)</sup>									
annual change in % (real)	4.2	4.9	1.2	-9.2	-1.4	-1.2	1	2.5	3
Gross agricultural production									
annual change in % (real)	4.4	-3.9	8.0	-0.8	-8.2	.	.	.	.
Construction output <sup>2)</sup>									
annual change in % (real)	9.4	2.4	11.8	-6.5	-15.9	-9	.	.	.
Employed persons - LFS, th, average	1586	1615	1636	1605	1541	1485	1470	1470	1480
annual change in %	0.8	1.8	1.3	-1.8	-4.0	-3.6	-1	0	1
Unemployed persons - LFS, th, average	199	171	149	160	206	235	.	.	.
Unemployment rate - LFS, in %, average	11.1	9.6	8.4	9.1	11.8	13.7	14	14	13
Unemployment rate, reg., in %, end of period	17.0	14.7	13.7	16.7	18.8	18.7	19	18.5	18
Average gross monthly wages, HRK	6634	7047	7544	7711	7679	7750	7750	7800	7850
annual change in % (real, net)	1.9	2.2	0.8	0.2	-0.5	-0.3	.	.	.
Consumer prices, % p.a.	3.2	2.9	6.1	2.4	1.1	2.3	2.5	2.4	2
Producer prices in industry, % p.a. <sup>3)</sup>	2.7	3.5	8.3	-0.4	4.3	6.4	4	3	3
General governm.budget, EU-def., % GDP <sup>4)</sup>									
Revenues	.	.	39.1	36.4	35.0	36	36	36	35.5
Expenditures	.	.	40.4	40.5	39.9	41	40	40	39
Deficit (-) / surplus (+)	-2.9	-2.4	-1.4	-4.1	-4.9	-5	-4	-4	-3.5
Public debt, EU-def., in % of GDP <sup>4)</sup>	35.4	32.9	29.2	35.1	41.3	43.9	48	52	55
Central bank policy rate, % p.a., end of period <sup>5)</sup>	3.50	4.06	6.00	6.00	6.00	6.00	.	.	.
Current account, EUR mn	-2623.9	-3114.6	-4196.7	-2379.7	-535.0	0	-300	-500	-600
Current account in % of GDP	-6.6	-7.2	-8.8	-5.2	-1.2	0	-0.6	-1.0	-1.2
Exports of goods, BOP, EUR mn	8463.6	9192.5	9814.0	7703.2	9102.3	9500	9600	10000	10600
annual growth rate in %	17.2	8.6	6.8	-21.5	18.2	4.4	1	4	6
Imports of goods, BOP, EUR mn	16807.8	18626.5	20607.8	15090.1	15054.3	14900	14900	15300	16100
annual growth rate in %	14.0	10.8	10.6	-26.8	-0.2	-1	0	3	5
Exports of services, BOP, EUR mn	8526.8	9114.7	10090.6	8453.9	8489.5	8750	8900	9200	9700
annual growth rate in %	5.9	6.9	10.7	-16.2	0.4	3.1	2	3	5
Imports of services, BOP, EUR mn	2750.6	2748.1	3016.0	2684.1	2603.0	2450	2500	2550	2700
annual growth rate in %	3.0	-0.1	9.7	-11.0	-3.0	-5.9	2	2	6
FDI inflow, EUR mn	2764.8	3651.3	4218.6	2379.8	280.9	1200	1500	.	.
FDI outflow, EUR mn	208.2	216.1	972.7	888.2	-112.3	50	.	.	.
Gross reserves of NB excl. gold, EUR mn	8725.3	9307.4	9120.9	10375.8	10660.3	11194.9	.	.	.
Gross external debt, EUR mn <sup>6)</sup>	29725.0	33720.8	39764.4	43745.3	46495.6	46500	.	.	.
Gross external debt in % of GDP <sup>6)</sup>	74.8	77.7	83.3	95.8	101.3	100.7	.	.	.
Exchange rate HRK/EUR, average	7.3228	7.3360	7.2232	7.3396	7.2862	7.4339	7.5	7.45	7.45
Purchasing power parity HRK/EUR	4.7875	4.7289	4.9004	5.0664	5.0929	5.1284	.	.	.

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

1) Preliminary and wiiw estimates. - 2) Enterprises with 20 and more employees. - 3) Domestic output prices. - 4) According to ESA'95, excessive deficit procedure. - 5) Average weighted repo rates. - 6) From 2008 and 2009 new reporting systems.

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