

Hermine Vidovic

Croatia: foreign debt impeding economic growth

The deceleration of economic activity already apparent in late 2004 continued during the first months of 2005. Construction activity slowed down steadily from July last year and external imbalances increased further. However, retail trade turnover and industrial output, performing disappointingly in the first quarter of the year, showed signs of recovery from April and May respectively. Consumer price inflation accelerated at the beginning of the year but slowed to 2.8% in May year on year.

Final data on 2004 obtained from the labour force survey indicate a 1.7% employment increase as compared to a year earlier and a decline of the unemployment rate to 13.8%. Labour market results available from registration data are traditionally more unfavourable: according to these data, employment stagnated in the first quarter of 2005 and registered unemployment was at 18.7% in April. Croatia's employment rate, at 54.5% in 2004, is very low by EU standards and ranks at the lower end of the scale if compared with the new EU member states or the other candidate countries; only Poland and the two candidate countries Turkey and Bulgaria report even lower rates.

On the external side, data from the customs statistics indicate a weak export performance for the first four months of 2005 (up by 6% in euro terms) coupled with an overall import growth of 9%. This resulted in a EUR 2.3 billion trade deficit, EUR 300 million more than in the same period a year earlier. As in the past few years, shipbuilding accounted for the biggest share of manufacturing exports (close to 40%), but reported a significant drop (by 37%) against the first four months of 2004. Current account data for 2005 are not yet available; considering the increased foreign merchandise trade deficit and a reported 4% drop in overnight stays, the current account deficit may have reached EUR 1.5 billion in the first quarter of 2005.

Combating rising foreign debt has been one of the main challenges for the Croatian authorities over recent years. In contrast to the agreement with the IMF signed in August 2004, under which Croatia committed itself to keeping the debt to GDP ratio at 77% (measured in euro terms), the ratio jumped to some 82% in December 2004. After a slight decline in the first two months of 2005, foreign debt rose again and reached EUR 23.5 billion or 84% of the 2004 GDP in April. The bulk of the rise was borne by the banking sector, accounting for 35% of total foreign debt. The most recent report of the World Bank on Global Development Finance has downgraded Croatia to a 'severely

indebted middle income country' from a 'moderately indebted middle income country' in the past couple of years.¹

In response to these developments, in order to reduce the incentives for external borrowing, the National Bank of Croatia *inter alia* raised the marginal reserve requirement rate from 30% to 40% and reduced the remuneration rate for the kuna portion of the reserve requirement allocated with the central bank from 1.25% to 0.75%. The Ministry of Finance, which had apparently not been informed about these steps, demurred that the new measures would trigger a reduction of the banks' liquidity and an increase in interest rates.

During the recent months the Croatian currency has appreciated steadily against the euro, reaching a three-year high at 7.3 HRK per euro in May, and prompting the National Bank to intervene on the foreign exchange market several times. Only recently the governor of the central bank, Mr. Rohatinski, blamed foreign-owned banks (that is, almost the entire sector) for exerting pressure on the foreign exchange market through the euro import from their mother banks and underlined that the costs of sustaining the current exchange rate system are becoming higher and higher.

According to final data, the general government closed with a 4.9% deficit to GDP in 2004, higher than agreed with the IMF. For 2005 the deficit is projected at 3.7%, but taking into account lower GDP growth than anticipated and the delayed restructuring of public expenditures this target seems to be out of reach. Data obtained for the first quarter of 2005 point to a HRK 6.1 billion deficit, almost double the value recorded in the same period a year earlier. In general, information on fiscal developments is non-transparent due to several methodological changes in the data compilation, thus making an assessment of the actual situation almost impossible. Croatia's public debt has been on a steady increase in both absolute and relative terms over the past couple of years. These tendencies continued during the first months of 2005 and may jeopardize Croatia's intentions to meet the Maastricht criteria by 2007.

In March the EU delayed the start of membership negotiations with Croatia as the country failed to cooperate fully with the war criminal tribunal ICTY in delivering war-crime fugitive general A. Gotovina to The Hague. This position was confirmed by a statement of EU officials in mid-June; the next talks on the issue are scheduled for the middle of July at the earliest. A postponement of the negotiations to the beginning of next year would seriously jeopardize Croatia's target date (2009) for full membership.

¹ According to the World Bank, a country is severely indebted if either its debt to GDP ratio is above 80% or its debt to exports of goods and services is above 220% – in both cases Croatia meets the criteria.

The results obtained for the first months of 2005 suggest a further deceleration of economic growth. Accordingly wiiw will revise its GDP forecast down to below 3%, from 3.5% earlier. Growth will be primarily supported by domestic demand, although (public) investment growth is expected to further slow down as compared to the robust growth over the last couple of years, particularly in construction investment. Thus, the private sector will have to be the main engine of growth. In view of the weakening of overall economic activity employment will stagnate or even slightly decline this year and in 2006. Similarly unemployment will remain at high levels. In 2005 the current account may close with a similar or slightly higher deficit than last year, given the increasing trade deficit and a reduction of overnight stays during the first months of the year. The high and growing foreign indebtedness coupled with persistently high fiscal deficits remain the main challenges in the years to come.

Table HR

Croatia: Selected Economic Indicators

	2000	2001	2002	2003	2004 ¹⁾	2004 1st quarter	2005	2005 forecast	2006 forecast
Population, th pers., mid-year ²⁾	4437	4437	4443	4442	4440	.	.	.	.
Gross domestic product, HRK mn, nom.	152519	165640	179390	193067	207082	47056	49574	219700	231900
annual change in % (real)	2.9	4.4	5.2	4.3	3.8	4.2	1.8	3	3
GDP/capita (EUR at exchange rate)	4502	4998	5451	5747	6222	.	.	.	.
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	5.6	0.3	2	3
Construction industry, hours worked ³⁾									
annual change in % (real)	-9.1	3.6	12.8	22.8	2.0	11.5	-6.6	.	.
Consumption of households, HRK mn, nom.	89637	98054	107427	113396	120312	28919	30605	.	.
annual change in % (real)	4.2	4.5	7.6	4.1	3.9	3.9	2.4	2	2.5
Gross fixed capital form., HRK mn, nom.	33281	36984	44114	53168	57141	13301	13617	.	.
annual change in % (real)	-3.8	7.1	12.0	16.8	4.4	8.9	0.3	4	4
LFS - employed persons, th, avg.	1553	1469	1528	1537	1563	.	.	.	.
annual change in %	4.1	-5.4	4.0	0.6	1.7	.	.	.	.
Reg. employees in industry, th pers., avg.	291.9	287.2	281.0	282.6	281.7	280.4	275.2	.	.
annual change in %	-2.5	-1.6	-2.2	0.6	-0.3	0.0	-1.9	.	.
LFS - unemployed, th pers., average	298.0	277.0	266.0	256.0	249.5	.	.	.	.
LFS - unemployment rate in %, average	16.1	15.9	14.8	14.3	13.8	.	.	13.5	13
Reg. unemployment rate in %, end of period	22.3	23.1	21.3	19.1	18.7	19.1	19.2	18.5	18
Average gross monthly wages, HRK	4869	5061	5366	5623	5985	5832	6087	.	.
annual change in % (real, net)	3.4	1.6	3.1	3.8	3.7	4.3	1.7	.	.
Consumer prices, % p.a. ⁴⁾	6.2	4.9	1.7	1.8	2.1	1.8	3.3	3	2.5
Producer prices in industry, % p.a.	9.7	3.6	-0.4	1.9	3.5	0.2	4.8	2	.
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	.
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	-1756.9	-1249.5	-1183.0	.	-1300	-1400
Current account in % of GDP	-2.5	-3.7	-8.7	-6.9	-4.5	-19.1	.	-4.4	-4.5
Gross reserves of NB excl. gold, EUR mn	3783.2	5333.6	5651.3	6554.1	6436.2	6178.5	6700.4	.	.
Gross external debt, EUR mn	11865.2	12827.6	15054.8	19810.6	22675.4	20604.2	22906.8	.	.
FDI inflow, EUR mn	1142.1	1502.5	1195.1	1788.4	921.4	265.9	.	.	.
FDI outflow, EUR mn	1.5	175.6	597.8	93.0	254.5	40.7	.	.	.
Exports of goods, BOP, EUR mn	4969.3	5318.8	5293.1	5571.7	6601.9	1483.4	.	6930	7350
annual growth rate in %	20.2	7.0	-0.5	5.3	18.5	7.2	.	5	6
Imports of goods, BOP, EUR mn	8468.6	9922.6	11253.5	12545.9	13326.7	2919.8	.	14390	15110
annual growth rate in %	17.0	17.2	13.4	11.5	6.2	6.9	.	8	5
Exports of services, BOP, EUR mn	4442.0	5481.3	5832.3	7679.7	7818.1	857.3	.	.	.
annual growth rate in %	26.6	23.4	6.4	31.7	1.8	9.0	.	.	.
Imports of services, BOP, EUR mn	1971.5	2178.5	2547.5	2632.8	2914.5	635.8	.	.	.
annual growth rate in %	0.3	10.5	16.9	3.3	10.7	19.9	.	.	.
Average exchange rate HRK/USD	8.28	8.34	7.86	6.70	6.04	6.09	5.72	.	.
Average exchange rate HRK/EUR (ECU)	7.63	7.47	7.41	7.56	7.50	7.61	7.51	7.4	7.5
Purchasing power parity HRK/USD	3.74	3.80	3.85	3.89	3.94	.	.	.	.
Purchasing power parity HRK/EUR	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; Eurostat; IMF; wiiw forecasts.