

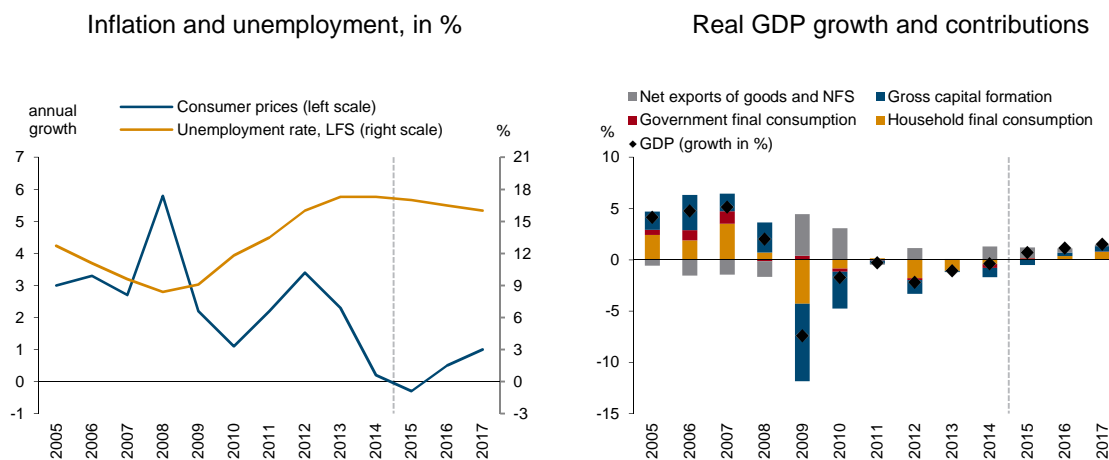


CROATIA: Mild recovery

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After six years of contraction, Croatia's economy has returned to a growth pattern. The turnaround has been backed by rising external demand and a mild recovery in household consumption and investments. GDP growth is expected to firm up over the years to come, fuelled primarily by EU-funded investments. Fiscal consolidation and deleveraging on the part of enterprises are the major obstacles to sustainable growth.

Figure 43 / Croatia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

GDP growth, having resumed in the last quarter of 2014 after six years of recession, continued during the first half of 2015. Foreign demand was the main driver behind the 0.8% rise in GDP in the first half of the year as compared with the corresponding 2014 period; also domestic demand contributed slightly positively to the expansion. Private consumption rose for the first time since 2011 owing to a mild recovery in the labour market, real wage increases and a reduction of personal income tax introduced at the beginning of the year. With the exception of a temporary increase in 2013, gross fixed capital formation grew for the first time since 2009 thanks to an improved absorption of EU funding. Construction output continued to shrink for the seventh consecutive year, although at a slower pace than in the years before. Industrial production growth took off in the second quarter of 2015, increasing by 1.5% during the first seven months as against the same 2014 period, with the highest growth rates reported for the manufacture of leather, the manufacture of rubber and plastics and in shipbuilding (after

years of contraction related to restructuring). Labour productivity has further increased due to continued layoffs. The situation in the labour market has been slightly improving in 2015: according to Pension Insurance data, employment rose by 0.4% during the first half of the year; Labour Force Survey data report an increase by even 2.2% along with the unemployment rate declining to 16.8%. The latter however, is still one of the highest among EU Member States, ranging third after Greece and Spain. Both real gross and net wages increased, by 1.3% and 3.4% respectively, in the first half of 2015.

External trade performed dynamically: during the first half of 2015, goods exports (up 10.3%) rose ahead of imports (up 6.1%, both in nominal euro terms). The trade deficit remained stagnant against the same period a year earlier. In trade with the EU, exports rose above average by 17%, while deliveries to CEFTA countries have slightly decreased, primarily due to a strong export decline in trade with Bosnia and Herzegovina, Croatia's main trading partner in the region. Trade with Russia shrank significantly both in terms of exports (-30%) and imports (-35%). Taking into account a somewhat lower trade deficit than in 2014 and assuming a rise in the services trade surplus due to record earnings from tourism, the 2015 current account will show an even more pronounced surplus than in 2014.

At the end of June 2015 the ratio of non-performing loans to total loans was 17.3% (up from 16.6% in June 2014). Out of the loans provided to the corporate sector, 30.9% were categorised as non-performing; the ratio of non-performing loans in total household loans was 12.1% (of which mortgage loans 34.8%). During the first seven months of 2015 bank lending both to the non-financial corporate sector and to private households was falling, in the latter case reflecting a long-lasting deleveraging process and tight labour market situation.

Ahead of the upcoming parliamentary elections in autumn this year, the Croatian government (parliament) has approved a series of (popular) measures. Already in February, a programme was launched following a government deal with the country's largest banks, telecommunications operators and public utility companies to write off debts of the country's poorest citizens. Another measure, which came into force at the beginning of October, is envisaged to fight energy poverty. Accordingly 60,000 to 70,000 poor households will receive vouchers worth HRK 200 or EUR 26 per month which can be used exclusively to pay electricity bills.

Finally, in September the Croatian parliament passed legislation allowing to convert Swiss franc loans into euro-denominated loans. Altogether there are 55,000 loans outstanding, amounting to HRK 23 billion (EUR 3.1 billion). The amended law envisages the conversion of the loans according to the exchange rate applicable on the date of loan disbursement, while the initial interest rate in Swiss francs will be replaced by the interest rate on euro loans. The conversion will be conducted on a voluntary basis. In return the banks will receive tax benefits. The entire cost of the conversion should be borne by banks and could reach, according to Croatian National Bank estimates, HRK 8 billion, reducing banks' capital adequacy from 23.5% to 19.7%. Already at the beginning of the year the government passed a bill freezing the exchange rate for those loans at HRK 6.39 per franc. In response to the law, five international banks active in Croatia stated that this move violates European law and bilateral investment treaties and announced to sue Croatia at the International Centre for Settlement of Investment Disputes in Washington. The ECB, too, has released an opinion⁴⁶ on the new law, stating, among other things, that the conversion of the loans may result in a decline of Croatia's foreign currency

⁴⁶ https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2015_32_f_sign.pdf

reserves and consequently affect the country's economic stability. It might also have negative effects on investors' sentiment 'due to a perceived increase of legal uncertainty' and 'financial costs for the banking sector may have a negative impact on the profitability, capitalisation and future credit potential of the affected credit institutions'.

Parliamentary elections will be held on 8 November 2015. The most recent opinion polls show a neck-and-neck race between the ruling coalition led by the Social Democratic Party under Prime Minister Milanovic and the conservative coalition led by HDZ, Croatia's main opposition party. Still, none of the main parties will reach a majority in the future parliament and will have to rely on coalition partners. Regarding the election programmes, HDZ, seeking advice from the IFO Institute Munich, calls – among other things – for a reduction of the budget deficit, more efficient administration, improvement of public procurement procedures, a reform of the health sector and the reduction of the grey economy. The Social Democrats want to focus on strengthening Croatia's competitiveness, improving the standard of living and social security, and increasing efficiency of the public sector. The creation of new jobs will have top priority. EU funding should play a major role in order to achieve these goals. Overall, it seems that economic policy will not change dramatically if HDZ wins the elections because, whatever government will be in power, it will have to comply with the recommendations under the excessive deficit procedure.

wiiw expects the Croatian GDP to grow by 0.7% in 2015, which is slightly higher than the forecast made in spring. The upward revision is mainly due to rising foreign demand (exports plus tourism) and the earlier than expected revival of household consumption. The country will continue to experience growth over the entire forecasting period; that growth will become more robust (up to 1.6%) driven, apart from external demand, also by a further recovery of domestic demand, particularly investments supported by EU funds. Private consumption will remain suppressed due to continued household deleveraging and still high unemployment. Downside risks to the outlook are: long-lasting fiscal consolidation coupled with growing public debt and corporate deleveraging.

Table 10 / Croatia: Selected economic indicators

	2011	2012	2013	2014 ¹⁾	2014 January-June	2015	2015 Forecast	2016 Forecast	2017
Population, th pers., average ²⁾	4,283	4,269	4,254	4,236	4,236	.	4,250	4,250	4,250
Gross domestic product, HRK mn, nom. ³⁾	332,587	330,456	329,571	328,431	156,769	158,580	329,700	335,300	344,100
annual change in % (real)	-0.3	-2.2	-1.1	-0.4	-0.7	0.8	0.7	1.2	1.6
GDP/capita (EUR at exchange rate) ³⁾	10,400	10,300	10,200	10,200	.	.	10,100	10,300	10,500
GDP/capita (EUR at PPP) ³⁾	15,500	16,000	16,100	16,000	.	.	.	.	.
Consumption of households, HRK mn, nom. ³⁾	195,325	195,623	195,623	193,524	96,070	96,321	.	.	.
annual change in % (real)	0.3	-3.0	-1.9	-0.7	-0.6	0.5	0.2	0.6	1.3
Gross fixed capital form., HRK mn, nom. ³⁾	67,471	64,820	65,257	62,639	30,985	31,231	.	.	.
annual change in % (real)	-2.7	-3.3	1.4	-3.6	-3.4	0.2	0.3	2.0	4.0
Gross industrial production ⁴⁾									
annual change in % (real)	-1.2	-5.5	-1.8	1.2	0.1	1.2	2.0	2.5	2.5
Gross agricultural production									
annual change in % (real)	-4.7	-9.4	4.2	-1.8	.	.	.	.	.
Construction output ⁴⁾									
annual change in % (real)	-11.3	-12.7	-4.7	-7.2	-8.5	-0.7	.	.	.
Employed persons, LFS, th, average ⁵⁾	1,493	1,566	1,524	1,566	1,538	1,573	1,600	1,630	1,660
annual change in %	-3.2	-3.6	-2.7	2.7	2.1	2.2	2.0	2.0	2.0
Unemployed persons, LFS, th, average ⁵⁾	232	297	318	327	329	318	330	320	320
Unemployment rate, LFS, in %, average ⁵⁾	13.5	16.0	17.3	17.3	17.7	16.9	17.0	16.5	16.0
Reg. unemployment rate, in %, end of period	18.7	21.1	21.6	19.6	18.3	16.1	.	.	.
Average monthly gross wages, HRK	7,796	7,875	7,939	7,953	7,939	8,026	8,000	8,200	8,400
annual change in % (real, gross)	-0.8	-2.3	-1.4	0.4	-0.2	1.3	1.3	1.8	2.0
Average monthly net wages, HRK	5,441	5,478	5,515	5,533	5,506	5,685	5,700	5,900	6,100
annual change in % (real, net)	-0.4	-2.6	-1.5	0.5	-0.2	3.4	3.0	2.5	2.5
Consumer prices (HICP), % p.a.	2.2	3.4	2.3	0.2	0.2	-0.2	-0.3	0.5	1.0
Producer prices in industry, % p.a.	7.0	5.4	-0.2	-2.6	-2.7	-3.5	0.0	1.0	1.0
General governm.budget, EU-def., % of GDP									
Revenues	41.0	41.7	42.5	42.3	.	.	42.7	42.9	42.5
Expenditures	48.5	47.0	47.8	48.1	.	.	48.2	47.9	46.5
Net lending (+) / net borrowing (-)	-7.5	-5.3	-5.4	-5.7	.	.	-5.5	-5.0	-4.0
Public debt, EU-def., % of GDP	63.7	69.2	80.8	85.1	.	.	90.0	93.0	95.0
Central bank policy rate, % p.a., end of period ⁶⁾	7.0	7.0	7.0	7.0	7.0	7.0	.	.	.
Current account, EUR mn ⁷⁾	-318	-22	438	340	-1,863	-1,280	450	240	150
Current account, % of GDP ⁷⁾	-0.7	-0.1	1.0	0.8	-9.1	-6.2	1.0	0.6	0.3
Exports of goods, BOP, EUR mn ⁷⁾	8,742	8,673	8,919	9,760	4,599	5,071	10,700	11,600	12,500
annual change in %	8.5	-0.8	2.8	9.4	14.2	10.3	10.0	8.0	8.0
Imports of goods, BOP, EUR mn ⁷⁾	15,126	14,970	15,498	16,116	8,023	8,511	17,100	18,100	19,000
annual change in %	8.2	-1.0	3.5	4.0	5.5	6.1	6.0	6.0	5.0
Exports of services, BOP, EUR mn ⁷⁾	9,367	9,641	9,838	10,265	3,391	3,763	11,300	12,100	12,900
annual change in %	4.7	2.9	2.0	4.3	2.3	11.0	10.0	7.0	7.0
Imports of services, BOP, EUR mn ⁷⁾	3,168	3,122	3,049	3,025	1,423	1,566	3,300	3,500	3,700
annual change in %	-0.2	-1.5	-2.3	-0.8	-1.3	10.0	9.0	6.0	6.0
FDI liabilities (inflow), EUR mn ⁷⁾	1,015	1,133	703	2,893	2,385	498	1,000	.	.
FDI assets (outflow), EUR mn ⁷⁾	-169	-64	-118	1,586	1,758	136	270	.	.
Gross reserves of NB excl. gold, EUR mn	11,195	11,236	12,908	12,688	12,335	13,734	.	.	.
Gross external debt, EUR mn ⁷⁾	46,397	45,297	45,958	46,664	46,390	48,913	49,100	48,400	48,000
Gross external debt, % of GDP ⁷⁾	103.7	103.0	105.6	108.4	107.8	113.5	114	111	108
Average exchange rate HRK/EUR	7.4342	7.5173	7.5735	7.6300	7.62	7.63	7.65	7.69	7.74
Purchasing power parity HRK/EUR	5.0056	4.8239	4.8114	4.8372	.	.	.	.	.

1) Preliminary. - 2) According to census April 2011. - 3) According to ESA'10. - 4) Enterprises with 20 and more employees. - 5) From 2012 according to census April 2011. - 6) Discount rate of NB. - 7) BOP 6th edition.

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