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## **Croatia: Speed of reform lost momentum**

***Croatia's economy is entering another year of recession in 2013. Given the need to consolidate public finances, a rapid recovery cannot be expected. Speeding up the stalling reform process becomes increasingly difficult due to high and persistent unemployment. Joining the EU in July 2013 may help to boost foreign investors' confidence, but positive effects from EU membership may be expected only in the medium term.***

Croatia's economy continued its downward trend starting from 2009, with GDP declining by close to 2% in 2012. Gross fixed capital formation contracted for yet another year. Private consumption fell due to the decline in disposable income (rising unemployment), while the decrease in government consumption was mainly resulting from fiscal consolidation. The contraction in investments was felt primarily in the construction sector, where output continued to decline sharply (-11%). The slump in industrial production has become even worse than in the two preceding years, with output dropping by over 5%. In manufacturing almost all sectors recorded a decline in production, including the shipbuilding industry, Croatia's single most important exporter. In January 2013 the European Commission gave green light to the privatization plans for the shipyard Brodosplit, envisaging state aid (support to the restructuring) to the shipyard in the amount of EUR 1.5 billion within a five-year period. The contract for Brodotrogir is initialled and should be signed soon, while the shipyard 3. Maj is to be sold to the Uljanik shipyard. The restructuring of the shipbuilding industry has been one of the major issues in Croatia's accession negotiations with the EU and will be closely monitored by the Commission until accession.

In response to the poor industrial performance characterized by low competitiveness and only minor foreign direct investments the Croatian Minister of Economy has announced a new industrial strategy for the country covering the period 2014-2020. The strategy, which will be presented in the course of the year, will reportedly focus on a combination of old and new industrial branches such as metal-working, food processing, pharmaceuticals, textiles and leather industries, shipbuilding, ICT, creative industries and the automotive industries, i.e. including almost everything, and does not reveal any real specification so

far. For the development of new branches the strategy envisages to encourage R&D investments by Croatian companies.

Based on customs statistics, external trade developments turned positive in the last quarter of 2012 mainly because of the export of ships. In the year as a whole, however, goods exports were only slightly up in nominal euro terms and imports almost stagnated. The resulting trade deficit fell by about EUR 200 million compared to a year earlier and reached EUR 6.5 billion. Thanks to a growing surplus in services trade due to rising earnings from tourism and a declining deficit in the income balance, the current account closed with a lower deficit than in 2011. At the same time the inflow of FDI fell substantially and amounted to only EUR 600 million.

Croatia's labour market deteriorated markedly during 2012. Labour force survey data indicate that employment fell by close to 5% in the course of the year while the unemployment rate jumped to 15.7% (13.5% in 2011). Youth unemployment soared to over 40% and is, along with Spain and Greece, among the highest in the EU. Registration data put the unemployment rate at 21% in December, the highest rate since 2003. Most of the newly registered unemployed came from the manufacturing industry, but for the first time also a higher number of employees who previously had worked in public administration, defence, health and education sectors were registered at the employment offices. The Ministry of Labour expects further employment cuts in 2013, thus a relaxation on the labour market can be expected only in 2014.

At the beginning of December the Croatian government adopted the 2013 state budget, which is based on the (ambitious) assumption of 1.8% GDP growth. The budget deficit is envisaged at 3.1% of the GDP, which is not only higher than projected in the 'Economic and Fiscal Policy Guidelines for the Period 2013-2015' adopted last July but also exceeding the 2012 level. In response, Standard & Poor's cut Croatia's sovereign credit rating from investment grade to junk, stating that the structural and fiscal reforms implemented so far have been insufficient to foster economic growth overhaul. In February 2013 also Moody's downgraded Croatia's rating to junk, reflecting the stalled recovery, lack of budget discipline and the vulnerability to external shocks.

Public debt rose from 47% of the GDP at the end of 2011 to an estimated 53% at the end of 2012. A large part of the debt increase was due to assuming the shipyards' debts by the government, the remainder accounted for the financing of the budget deficits.

So far 21 EU member states have ratified Croatia's accession treaty. Following protracted and tough negotiations on an unresolved banking dispute dating back to the dissolution of Yugoslavia, also Slovenia announced its willingness to ratify the treaty.

wiiw has revised its previous GDP growth forecast for 2013 downwards from 1% to minus 0.5%, since the expected slight rebound in (public) investment activities will not be sufficient to offset declining household demand and a recovery in Croatia's main trading partners is not yet in sight. A return to modest growth might be expected in 2014. Employment will continue to contract; the LFS unemployment rate is expected to increase to 16% in 2013 and will remain at high levels due to the poor prospects for GDP growth. Household consumption will remain suppressed as a consequence of high unemployment, household deleveraging and weak credit activity; joining the EU in July 2013 may help to boost foreign investors' confidence, but positive effects from EU membership might be expected only in the medium term. As for the time being, EU cohesion and structural funds may serve as one of the main sources of infrastructure investments in the country. Maintaining the stability of the exchange rate will remain the main goal of the Croatian National Bank; an early euro adoption is not in sight. The need to speed up structural reforms and further fiscal consolidation against the background of high unemployment will remain the major challenge for the years to come.

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**Croatia: Selected Economic Indicators**

	2008	2009	2010	2011	2012 <sup>1)</sup>	2013	2014 Forecast	2015
Population, th pers., mid-year	4434.5	4429.1	4417.8	4288.0	4280.0	4280	4280	4280
Gross domestic product, HRK mn, nom.	343412	328672	326980	333956	339100	347500	359800	376200
annual change in % (real)	2.1	-6.9	-1.4	0.0	-1.8	-0.5	1.5	2.5
GDP/capita (EUR at exchange rate)	10700	10100	10200	10500	10500	10800	11200	11700
GDP/capita (EUR at PPP)	15800	14500	14400	15400	15400	.	.	.
Consumption of households, HRK mn, nom.	197936	188859	189314	194318	196900	.	.	.
annual change in % (real)	1.3	-7.6	-0.9	0.2	-2.0	-2.0	0.0	1.0
Gross fixed capital form., HRK mn, nom.	93930	80367	67254	62746	62300	.	.	.
annual change in % (real)	8.7	-14.2	-15.0	-7.2	-4.0	1.5	3.0	5.0
Gross industrial production <sup>2)</sup>								
annual change in % (real)	1.2	-9.2	-1.4	-1.2	-5.5	1.0	2.5	3.0
Gross agricultural production								
annual change in % (real)	8.0	-0.8	-8.2	-1.0	.	.	.	.
Construction output <sup>2)</sup>								
annual change in % (real)	11.8	-6.5	-15.9	-9.1	-11.0	.	.	.
Employed persons, LFS, th, average	1636	1605	1541	1493	1420	1390	1400	1410
annual change in %	1.3	-1.8	-4.0	-3.2	-4.9	-2.0	1.0	1.0
Unemployed persons, LFS, th, average	149	160	206	232	265	.	.	.
Unemployment rate, LFS, in %, average	8.4	9.1	11.8	13.5	15.7	16.5	16.0	15.5
Unemployment rate, reg., in %, end of period	13.7	16.7	18.8	18.7	21.1	21.0	19.5	18.0
Average gross monthly wages, HRK	7544	7711	7679	7796	7850	7900	7950	8000
annual change in % (real, net)	0.8	0.2	-0.5	-0.4	-2.5	.	.	.
Consumer prices, % p.a.	6.1	2.4	1.1	2.3	3.4	3.0	2.0	2.0
Producer prices in industry, % p.a. <sup>3)</sup>	8.3	-0.4	4.3	6.3	7.0	5.0	3.0	3.0
General governm.budget, EU-def., % of GDP <sup>4)</sup>								
Revenues	39.3	37.1	35.9	35.5	34.5	.	.	.
Expenditures	40.6	41.3	40.9	40.6	39.0	.	.	.
Net lending (+) / net borrowing (-)	-1.4	-4.2	-5.0	-5.1	-4.5	-4.0	-3.5	-3.0
Public debt, EU-def., % of GDP	29.3	35.8	42.2	46.7	53.0	56.6	60.6	63.0
Central bank policy rate, % p.a., end of period <sup>5)</sup>	9.0	9.0	9.0	7.0	7.0	.	.	.
Current account, EUR mn	-4256.3	-2279.3	-449.9	-393.9	-300.0	-500	-600	-700
Current account, % of GDP	-9.0	-5.1	-1.0	-0.9	-0.7	-1.1	-1.3	-1.4
Exports of goods, BOP, EUR mn	9752.7	7674.5	9063.6	9774.0	9530.0	9800	10200	10700
annual growth rate in %	6.5	-21.3	18.1	7.8	-2.5	3.0	4.0	5.0
Imports of goods, BOP, EUR mn	20385.1	14881.6	14809.1	15921.9	15920.0	16400	17200	18200
annual growth rate in %	9.4	-27.0	-0.5	7.5	0.0	3.0	5.0	6.0
Exports of services, BOP, EUR mn	10090.6	8640.2	8649.4	9005.4	9550.0	9900	10400	10900
annual growth rate in %	10.7	-14.4	0.1	4.1	6.0	4.0	5.0	5.0
Imports of services, BOP, EUR mn	3236.9	2949.9	2875.7	2818.9	2880.0	3000	3200	3400
annual growth rate in %	17.8	-8.9	-2.5	-2.0	2.2	3.0	6.0	6.0
FDI inflow, EUR mn	4218.6	2415.0	297.5	1075.3	600.0	.	.	.
FDI outflow, EUR mn	970.2	888.1	-113.2	27.2	-250.0	.	.	.
Gross reserves of NB excl. gold, EUR mn	9121	10376	10660	11195	11300	.	.	.
Gross external debt, EUR mn <sup>6)</sup>	39764	43745	46496	45733	46000	.	.	.
Gross external debt, % of GDP <sup>6)</sup>	83.6	97.7	103.6	101.8	102.0	.	.	.
Exchange rate HRK/EUR, average	7.2232	7.3396	7.2862	7.4339	7.5175	7.5	7.5	7.5
Purchasing power parity HRK/EUR	4.9004	5.1169	5.1309	5.0661	5.1560	.	.	.

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) Discount rate of NB. - 6) From 2008 and 2009 new reporting systems.

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