

## 28. CROATIA

### Mild recovery after strong contraction

#### The economy decelerated markedly in the first half of the year...

Over the last few years, Croatia enjoyed relatively strong economic growth, averaging 4.3% in 2004-08. The growth performance was primarily domestic-demand-driven, fuelled by large capital inflows and strong credit growth. This was accompanied by a marked expansion of non-tradable industries, such as retail, construction and the financial sector. The global financial crisis and economic slowdown in Croatia's main trading partners started to affect the Croatian economy in the last quarter of 2008, when domestic demand and trade flows declined abruptly. In the first half of 2009, Croatia went into a deep recession. Real GDP growth declined markedly – by 6.5% year-on-year compared to 2.4% in 2008. The contraction in output was mainly driven by a considerable drop in domestic demand. Private consumption fell by around 9.7% and real investment dropped by 12.6%. Only government consumption maintained positive growth of close to 2.6%, as spending was not reduced in line with falling revenues. All in all, domestic demand posted a negative contribution to GDP growth of 12.3 pp. At the same time, total exports declined by 17% year-on-year, though less strongly than total imports (-22.8%), resulting in a positive contribution by net exports to GDP growth of 5.8 pp.

#### ...but the downturn is expected to be less pronounced in the remainder of 2009...

Recently published high frequency indicators suggest a further contraction of the economy in the third quarter. Industrial production and retail trade recorded strong declines in the two months of July and August of 8.7% and 14% year-on-year respectively.

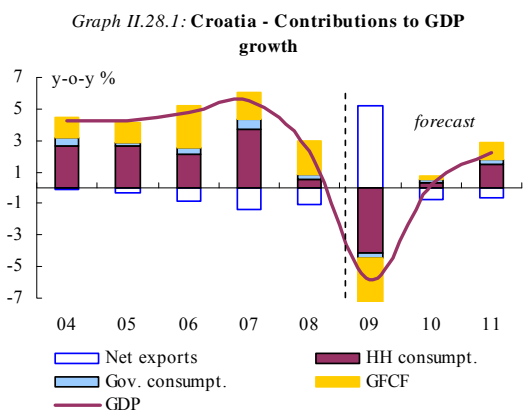
However, there are some signs that the pace of economic downturn has somewhat moderated recently. In particular, revenues from tourism came out better than expected and seasonally adjusted production data point to a marginal positive growth in the second compared to the first quarter. A slowly improving external environment is expected to lead to a moderation of export losses towards the end of the year. External financing constraints have somewhat eased, and the

deceleration of credit growth is set to stop in the second half of 2009. Therefore, a continuation of a very modest recovery on a quarterly basis is to be expected in the third and fourth quarter. This will however not be sufficient to avoid a significant decline in real GDP for the year as whole. The forecast projects a fall in GDP of close to 6% year-on-year.

#### ...followed by a zero growth rate in 2010 and continued mild recovery in 2011

The outlook for 2010 remains rather uncertain. It is still to be seen whether recent improvements in the external environment will translate into a strengthening of external demand. External financing constraints have eased somewhat in the course of the year, as evidenced by an increase in the external liabilities of domestic banks. However, a higher risk awareness among potential investors and the huge debt amortisation obligations weighing on both the private and general government sectors are likely to constrain financing for new investment. Domestic confidence levels and disposable incomes may not recover quickly, as the unemployment rate is set to increase and the number of employed to fall. Credit growth has decelerated significantly during the crisis, due to both demand and supply factors. Lower demand for loans as well as tighter financing constraints and higher risk awareness by banks have led to a slowdown in bank lending, particularly to private households. Although the banking sector is well-capitalised, sound and profitable, credit activity to the private sector will only slowly accelerate. Moreover, important public sector borrowing requirements limit the availability of credit to the private sector. Therefore, relatively low growth of private sector borrowing, in combination with higher interest rates, is expected to continue to put a brake on economic activity, particularly over the first part of the forecast horizon. Public consumption and investment are unlikely to accelerate in view of the fiscal constraints and huge refinancing needs of the public sector. On this basis, the forecast projects that the Croatian economy is likely to stagnate in real terms in 2010 on a year-on-year basis. Upside risks are mainly related to a faster-than-projected economic recovery in the EU as well as to the clear prospect of Croatia's accession in the near future which may provide additional impetus to the

economy, through stronger net FDI flows, inter alia. For 2011, the forecast projects a small positive growth of around 2%, mainly based on a slight acceleration of private consumption and investment growth, while net exports continue to contribute negatively to output growth.



#### External deficits are likely to fall temporarily

As a result of the financial crisis, the high external deficits of the past years have undergone severe adjustments. Reduced capital inflows and a contraction of domestic demand have led to a sharp reduction of trade and current account deficits. In the first half of 2009, the current account deficit declined by around 40% year-on-year. In terms of GDP, it fell from 9.3% in 2008 to 6% annualised in June. As to the outlook, total exports are expected to fall less strongly in the second half of 2009, and to slightly increase in 2010, in line with an expected strengthening of foreign demand in key trading partner countries. Total imports are likely to continue to contract at a stronger pace than exports through 2009, and will pick up only slowly thereafter. In light of expected trade flows and on the assumption that external financing constraints may somewhat persist, the current account balance is projected to fall to around 6% of GDP in 2009 and to slightly widen to around 7¼% on average over the forecast period, mainly due to an expected increase in commodity prices.

#### Inflation pressures to remain low

Annual inflation has fallen markedly from its peak of 8.4% in July 2008, as a result of rapidly contracting domestic demand and lower commodity prices. Inflationary pressures are expected to remain low over the forecast horizon. Domestic demand is set to only slowly and

gradually recover. Cost push pressures are expected to remain limited as the growth of unit labour costs will slow down. Upside risks are related both to foreign and domestic factors. On the external front, somewhat higher prices for imported raw material are likely to have some effect on the domestic price level. Moreover, some mild inflationary pressures will result from the recent increase of VAT (by 1pp.) and excises as well as further adjustments of administrative prices, which will be necessary in the context of EU accession. At the same time, it is reasonable to assume that a stability-oriented monetary policy framework will help to prevent a significant re-acceleration of inflation over the medium term.

#### Labour market performance to suffer eventually

Wage developments have so far been moderate and remained in line with productivity growth. The government made an attempt to reverse earlier public sector wage increases which should contribute to limiting wage pressures in 2009 and 2010. In addition, the economic slowdown means that only moderate increases in labour costs in the private sector are expected.

As elsewhere, slowing growth and investment dynamics will have an impact on labour market developments with some delay. In 2009, employment is set to fall and the unemployment rate (labour force survey) to increase. The slight recovery of economic activity forecast for 2010 and 2011 is expected to somewhat ease the pressures on the labour market, but not yet to support a significant reduction of unemployment.

#### Fiscal deficit is widening significantly despite re-balancing measures

Fiscal policy was strongly affected by the crisis from late 2008, when revenues started to underperform markedly in line with declining economic activity. While some short-term adjustments were made in late 2008 to keep the deficit in line with the envisaged target, public finances came under increasing pressure in 2009. In the first half, state budget revenues declined by 8.6% year-on-year while total spending increased by 7.9%. The budget balance turned into a deficit, equivalent to 2.2% of projected GDP, compared to a small surplus in the same period a year ago. A bleaker-than-expected economic outlook and worsening fiscal trends forced the authorities to

adopt a second and, shortly thereafter, a third budget revision in July. The re-balancing efforts foresaw some spending cuts, but were mostly concentrated on measures to compensate for falling revenues. This included, among other things, a special tax on income, a VAT increase of 1 pp., and increases in excises. Despite those adjustments, the planned fiscal deficit increased to 3.3% of GDP, compared to an original budget target of 1.4% of GDP. There remain downside risks to the 2009 budget execution: if the economic downturn persists for longer than expected, government revenues would be reduced further. Also, pressures for more government activism could result in higher-than-projected spending to combat the recession.

The forecast projects the fiscal deficit to increase to around 3½%-4% of GDP in 2009. A mild economic recovery and stronger revenue performance are expected to support a reduction of the deficit to around 3% in 2010. The general government debt-to-GDP ratio is set to increase from 33.3% to around 39½% of GDP.

Overall, public finances in Croatia are expected to remain under pressure as downside risks are evident on both the revenue and spending side of the budget. Therefore, a key challenge will be to design and implement a credible medium-term

fiscal strategy aimed at reducing budget rigidities and enhancing the efficiency and quality of public spending. Such a strategy would need to be supported by a continuation and acceleration of economic restructuring on a broader front as well as by deeper reforms of the social benefit system.

Table II.28.1:

**Main features of country forecast - CROATIA**

	2008			92-05	Annual percentage change					
	bn HRK	Curr. prices	% GDP		2006	2007	2008	2009	2010	2011
GDP	342.2	100.0	-	4.7	5.5	2.4	-5.8	0.2	2.2	
Private consumption	202.2	59.1	-	2.7	6.2	0.8	-7.0	0.5	2.5	
Public consumption	63.5	18.6	-	5.0	3.4	1.9	-2.0	1.0	2.0	
Gross fixed capital formation	94.3	27.6	-	10.9	6.5	8.2	-13.0	1.0	4.0	
of which : equipment	-	-	-	-	-	-	-	-	-	
Exports (goods and services)	143.4	41.9	-	6.5	4.3	1.7	-13.4	1.0	1.1	
Imports (goods and services)	172.0	50.3	-	7.4	6.5	3.6	-21.5	2.5	2.5	
GNI (GDP deflator)	330.7	96.6	-	4.6	5.8	1.7	-6.7	0.3	2.4	
Contribution to GDP growth :										
Domestic demand			-	5.3	6.1	3.0	-8.2	0.7	2.9	
Stockbuilding			-	0.4	0.8	0.4	-2.9	0.2	0.0	
Foreign balance			-	-0.9	-1.4	-1.1	5.4	-0.7	-0.7	
Employment			-	3.9	3.5	1.1	-1.0	0.5	0.5	
Unemployment rate (a)			-	11.2	9.6	8.4	10.0	9.8	9.4	
Compensation of employees/head			-	3.9	5.3	9.3	1.5	3.3	4.9	
Unit labour costs whole economy			-	3.0	3.3	7.9	6.7	3.6	3.1	
Real unit labour costs			-	-0.4	-0.7	1.4	3.8	0.6	0.5	
Savings rate of households (b)			-	-	-	-	-	-	-	
GDP deflator			-	3.4	4.0	6.4	2.8	3.0	2.5	
Harmonised index of consumer prices			-	3.2	2.9	6.1	2.6	3.0	3.0	
Terms of trade of goods			-	-	-	-	-	-	-	
Trade balance (c)			-	-21.3	-22.0	-22.9	-17.3	-18.2	-18.8	
Current account balance (c)			-	-7.0	-7.6	-9.3	-6.3	-6.9	-7.7	
Net lending(+) or borrowing(-) vis-à-vis ROW (c)			-	-7.3	-7.5	-9.2	-	-	-	
General government balance (c)			-	-3.0	-2.5	-1.4	-3.7	-3.0	-2.4	
Cyclically-adjusted budget balance (c)			-	-	-	-	-	-	-	
Structural budget balance (c)			-	-	-	-	-	-	-	
General government gross debt (c)			-	35.7	33.1	33.5	37.8	39.2	39.3	

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.