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Highlights in this issue:

- A strong rise in gross external debt has made Croatia more vulnerable to external shocks.
- The current account deficit has widened, driven by strong investment growth and public deficits.
- Further fiscal consolidation and deeper structural reforms are needed to address external imbalances and raise potential output.

External imbalances in Croatia - A matter of concern?

By U. Stamm and M. Macovei*

Summary

Since the early 1990s Croatia has managed a rather successful transition process with solid growth, low inflation and exchange rate stability. Better integration into international financial markets, capital account liberalisation and banking sector reform have facilitated access to foreign financing and opened the country to strong and persistent capital inflows. A significant increase in Croatia's external debt over the last few years, and a recent widening of the current account deficit, have attracted the attention of policymakers and external observers alike. This Country Focus argues that a rise in external indebtedness has made Croatia more vulnerable to potential shocks, but also finds that sizeable foreign assets of the banking system and evidence about the existence of unrecorded foreign exchange holdings by the private non-banking sector mitigate external risks. Current account deficits have been driven by strong investment growth rather than a decline in domestic savings, thus providing some reassurance on sustainability issues. The Country Focus concludes that, in the specific setting of Croatia, further fiscal consolidation remains a key instrument to address external vulnerabilities and allow for a much needed further expansion of private-sector activities. In this context, deeper structural reforms could trigger a stronger supply response, raise potential output and improve competitiveness on a broader front.

A significant rise in gross external debt

Croatia's foreign indebtedness has risen significantly over the last few years, in both absolute and relative terms. Over the period 2001-2006 its gross external debt increased by more than €16 billion, from 60% to around 85% of GDP. The strongest increases were in 2003 and 2004, when the debt ratio rose by almost 20 percentage points of GDP. According to the World Bank classification, Croatia turned from a moderately to a severely indebted middle-income country in 2004. The recent growth and level of Croatia's gross external debt appear relatively high compared with most Central and Eastern European countries. Regional comparison shows that only Estonia, Latvia, Hungary and Slovenia have experienced similar debt dynamics over the last five years. Nonetheless, Estonia and Latvia benefit from harder pegs, i.e. currency boards and budgets close to balance or in surplus, whereas Slovenia adopted the euro on 1 January 2007.

The rise in external debt has been accompanied by a major change in its distribution between domestic sectors. Prior to 2001 foreign borrowing was driven primarily by the public sector. Financing requirements were high due to massive reconstruction needs and infrastructure investment following the regional conflicts in the early 1990s. As a result, the public sector held the largest share of total external debt

Gross external debt rose by around 25% of GDP over the period 2001-2006

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The composition of external debt between the public and private sectors has changed

(44%), equivalent to around 27% of GDP in 2001. Since early 2002 the situation has changed dramatically. The public sector external debt-to-GDP ratio as well as its share in total debt declined, partly as a result of a deliberate move towards tapping the domestic capital market. At the same time, the external debt of the private sector has started to grow strongly. This trend has been driven, in particular, by a strong increase in foreign borrowing by domestic banks, facilitated by foreign ownership and easy access to financing from parent banks in neighbouring EU countries. As a result, the gross external debt of the banking sector increased from 11% of GDP in 2001 to above 30% in 2006, and its share of total external debt almost doubled. Since 2003 direct external borrowing by firms has expanded rapidly, *inter alia* in response to administrative measures taken by the central bank to reduce the growth of domestic credit.

Chart 1: Gross external debt of peers (% of GDP)

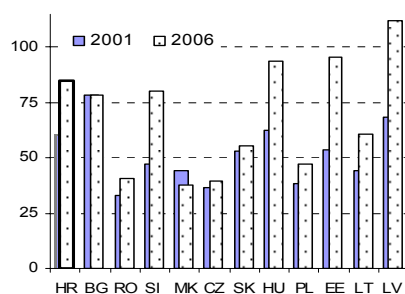
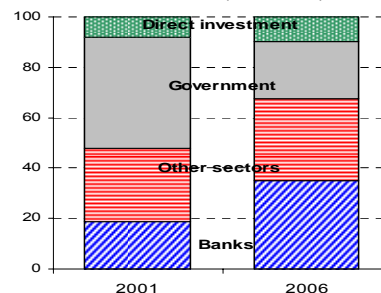


Chart 2: Sectoral composition of external debt (% of total)



... has increased the country's external vulnerability...

Standard debt indicators paint a mixed picture of the external vulnerability of the Croatian economy (Mihaljek 2004) but generally do not suggest the emergence of any debt-servicing problem in the near future. Liquidity indicators, such as the debt-service-to-GDP or interest-payments-to-exports ratios, have remained relatively benign over the last few years and raise no immediate concerns. However, short-term debt has risen steadily over recent years, in both absolute and relative terms, and increased roll-over risks. It reached a still fairly benign level equivalent to around 55% of official reserves at end-2006. Moreover, the large share of outstanding debt denominated in foreign currency on the balance-sheets of firms and households makes them vulnerable to major moves in the exchange rate. In addition, any further rise in interest rates in the euro area could trigger an increase in debt service obligations over the medium term.¹

No immediate debt problems despite increased external vulnerabilities

At the same time, *net* external debt is another useful indicator to assess the country's external imbalances, as it takes into account not only foreign liabilities but also foreign assets. In the case of Croatia these take the form of the sizeable official foreign exchange reserves and foreign assets of the banking sector. Net of those assets, external debt stood at a considerably lower level at the end of 2006 – around 45% of GDP. Although the net external debt ratio has also risen strongly over recent years, as domestic banks have reduced their foreign assets to refinance domestic credit activities, the level appears relatively moderate.

"Net" external debt is significantly lower

Finally, Croatia's "real" net external debt may actually be even lower than suggested above. Interestingly, the available data show that over the last few years the increase in the amount of net external debt has persistently been larger than the current account deficit. Normally, the change in net external debt should be lower than the current account balance for the corresponding period, as financial resources are not usually entirely of a debt-creating nature. The above-mentioned discrepancy points to some "over-financing" and possibly suggests the existence of significant unrecorded private-sector holdings of foreign exchange assets.

The current account deficit has widened ...

Croatia's current account deficit varied over time and averaged 6.5% of GDP over the period 2001-2006, similar to the average for 1996-2000. It widened from 5.2% of GDP in 2004 to 7.7% of GDP in 2006. In comparison with its peers in Central and South-Eastern Europe, Croatia's current account deficit does not appear excessive. On average, over the last few years it was significantly larger than the deficits reported by neighbouring countries such as Slovenia and the former Yugoslav Republic of Macedonia or by some Central European countries but smaller than the current account gaps recorded in the Baltic states, Romania and Bulgaria.

The current account deficit has widened, but does not appear excessive compared with peers

Chart 3: Current account deficit of selected countries (% of GDP)

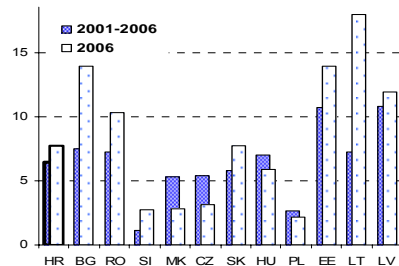
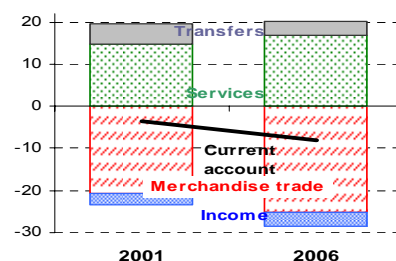


Chart 4: Breakdown of the current account balance (% of GDP)



Surpluses in services partly offset the trade deficit

One typical feature of Croatia's current account is a significant deficit in merchandise trade, offset to a large extent by a surplus in services, mainly resulting from tourism. From 2001 to 2006 imports grew, on average, faster than exports and the trade deficit rose from 20.7% to above 25% of GDP. In the same period net income from services increased from 14.7% to around 17% of GDP and "financed" about two thirds of the trade gap. The income balance remained negative over this period, with an average deficit of 3% of GDP largely driven by net factor payments on the rising foreign debt and foreign direct investment. However, reinvested earnings recorded as offsetting FDI inflows on the financial account were equivalent to, on average, around half of the deficit of the income balance, thus reducing financing requirements considerably. Finally, net transfers from abroad, largely in the form of remittances, were a significant and fairly stable source of financing worth around 4.4% of GDP in the period 2001-2006.

... reflecting strong growth in investment ...

Investment has grown faster than savings

A current account deficit represents a country's balance between domestic savings and investment. Any increase in the current account deficit could reflect either a decline in savings or a rise in investment or a combination of the two. Croatia's current account performance over the last five years has been largely driven by the strong growth in investment. Massive government capital spending, particularly in the road transport sector, played a significant role initially. Total gross fixed capital formation rose markedly (by 14% in 2002, by 25% in 2003 and by around 5% to 10% since then), jumping from around 24% of GDP in 2001 to around 33% in 2006. Interestingly enough, the domestic savings ratio rose too, from 20% to 25% of GDP, as growth in private consumption remained, on average, below GDP growth.

... and relatively large fiscal deficits

On average, fiscal deficits were the main driver of the savings/investment gap

A sector-by-sector breakdown of domestic savings and investment balances in Croatia in the period 2001-2006 shows² that government finances had a significant impact on the current account. With the exception of 2002 and 2006, the general government deficit has been larger than the private-sector gap. On average, the general government deficit stood at around 4.4% of GDP, which was about two times the average deficit of the private sector. The sharp widening of the current account deficit in 2002 corresponds to a strong increase in investment and in private consumption. In 2003 and 2004 a slowdown of growth and a moderation of private consumption led to a significant increase in the private-sector savings-to-GDP ratio. This partly compensated for an increase in the general government deficit and thus facilitated a gradual reduction of the current account deficit. Since 2005 the situation has changed significantly. The private-sector gap has widened considerably on the back of stronger private investment and a decline in private-sector savings. At the same time, moderate fiscal consolidation has led to a narrowing of public-sector deficits and helped contain any stronger widening of the current account deficit.

Table 1: Croatia - Investment and savings (as % of GDP)

	2001	2002	2003	2004	2005	2006e
Savings/investment gap	-3.7	-8.7	-7.3	-5.1	-6.4	-7.7
Savings	20.3	20.4	23.8	25.5	24.6	25.1
Investment	23.9	29.1	31.1	30.6	31.0	32.8
General government	-6.5	-4.1	-5.5	-4.1	-3.8	-2.2
Savings	-4.0	-0.2	-0.2	0.3	0.1	1.2
Investment	2.5	3.9	5.3	4.4	3.9	3.5
Private sector	2.8	-4.6	-1.8	-1.0	-2.6	-5.5
Savings	24.3	20.6	24.0	25.2	24.5	23.8
Investment	21.5	25.2	25.8	26.2	27.1	29.3

Source: CNB, MoF, own calculations

Financing the current account deficits was not difficult

Following the normalisation of financial relations with external creditors in the mid-1990s in the wake of the Paris and London Club agreements, Croatia regained access to international capital markets. Since then the Croatian economy has encountered no balance of payments or external financing problems and has gained wide access to international capital markets. The country has attracted strong and persistent capital inflows, which have led to a steady accumulation of official foreign exchange reserves as a result of frequent foreign exchange interventions by monetary authorities in the policy context of a tightly managed float.

Table 2: Balance of payments (as % of GDP)

	2001	2002	2003	2004	2005	2006e
Direct investment, net	5.9	2.4	6.4	2.5	3.9	7.8
Portfolio investment, net	3.0	-1.8	3.4	0.8	-3.4	-0.6
Other investment, net	1.8	11.5	6.1	5.0	12.0	9.2
Reserve assets*	-6.9	-3.0	-4.7	-0.2	-2.6	-4.1
Errors and omissions	-0.8	-2.5	-4.1	-3.1	-3.3	-4.2
Current account balance	-3.7	-8.7	-7.3	-5.1	-6.4	-7.7

* (-) increase (+) decrease. Source: CNB

Strong capital inflows ...

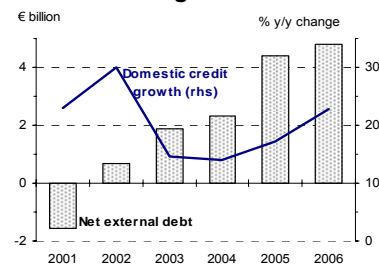
Total net capital inflows over the period 2001–2006 exceeded €20 billion and mostly took the form of net FDI (€7.2 billion) or other investments (€13.7 billion), while portfolio investments played only a minor role.

FDI flows are usually considered as longer term, less reversible and largely non-debt-creating flows. From 2001 to 2006 net FDI inflows into Croatia accounted for close to 5% of GDP or more than two thirds of the current account deficit on average, fairly similar to the period 1996-2000.

Nonetheless, FDI inflows were quite volatile, driven by privatisation to a large extent, and almost 40% of the total was allocated to financial

or real estate activities. Eventually green-field investment will need to play a more important role, which requires significant improvements to the business environment (for further details, see the European Commission's "Croatia 2006 Progress Report"). The most recent World Bank survey on the *ease of doing business* puts Croatia in 124th place out of 175 countries, fairly low compared with its peers.

Chart 4: Banks' net foreign debt and credit growth



A significant share of total net inflows (65%) is recorded as other investment, in which financial transactions by domestic banks play a particularly important role. After the privatisation of almost the entire banking sector in 2000 and 2001 and sales to foreign investors, strong foreign borrowing transformed the domestic banking sector's position from a net creditor to a net debtor in 2002. As seen in other transition economies, external funds were increasingly used to finance strong expansion of domestic credit, in particular to private households. As a result, outstanding credit to the household sector exceeded total credit to enterprises by about 7 percentage points of GDP at the end of 2006. However, the corporate sector in Croatia strongly expanded its direct borrowing abroad, as the recent surge in cross-border lending to non-banks which reached around 27% of GDP in 2006 suggests. Direct corporate borrowing seemed to have also risen in response to central bank measures aimed at curbing domestic credit growth.

Another striking characteristic of Croatia's balance of payments is the very large and negative net errors and omissions position. It averaged around 3% of GDP over 2001-2006, accounting for almost half the current account deficit during this period. Net negative errors and omissions can in principle arise from statistical discrepancies or possible underreporting of the current account deficit. However, given their magnitude, they may also reflect, to a large extent, constant accumulation of unrecorded foreign exchange holdings by the private non-banking sector in Croatia. Such a phenomenon is supported by anecdotal evidence and may be related to the high degree of euroisation of the Croatian economy. To that extent, it explains why the measured increase in net external debt exceeded the current account deficits, despite the fact that the latter have been financed largely by non-debt-creating inflows.

... increasingly driven by banks' external borrowing

BOX: Croatia's exchange rate policy framework

The current monetary and exchange rate policy framework in Croatia has been in place for practically the last ten years. It has largely focused on exchange rate stabilisation with a view to maintaining price stability. The official "managed float" is sometimes described as a "quasi-currency board". Money supply (M1) is more than covered by the central bank's foreign exchange reserves. The authorities have never announced an explicit exchange rate target, but the tolerance for exchange rate movements has been relatively low and foreign exchange interventions have taken place frequently and quite systematically.

Monetary and exchange rate policy to blame?

It has been argued (Vidovic/Gligorov 2004, 2006) that the specific monetary policy framework with its focus on exchange rate stabilisation has not been supportive to stronger export growth: exceptional nominal stability would have caused an overvalued real exchange rate, favouring strong import growth and acting as a deterrent to better export performance. According to this view, a more flexible exchange rate system, including the option of devaluations or successive managed depreciations, would have been conducive to raising price competitiveness and exports, resulting in lower current account deficits and lower external debt levels.

Would managed depreciation work?

Critics claimed that greater exchange rate flexibility would have probably led to appreciation rather than depreciation of the kuna. Foreign exchange interventions have mostly been undertaken to stem appreciation pressures. Achieving real depreciation against strong and persistent capital inflows would have required even stronger foreign exchange interventions with the risk of boosting liquidity and undermining price stability (Kraft, Stučka 2002). Also, it could be argued that the alleged blessings of a devaluation may only be temporary. The adjustment of domestic prices and wages to the new equilibrium takes some time but, once achieved, cancels out the previous "competitive" advantage.

In the meantime, resources are transferred from importers and consumers to exporting industries. Debtors, in particular foreign ones, are favoured at the expense of creditors. Foreign exchange intervention does not appear to be an adequate substitute for the necessary market adjustment of relative prices.

Moreover, the effect of any real depreciation on the trade balance could be small, due to the huge import intensity of manufacturing and tourism in Croatia. An empirical study by Stučka (2003) found that a permanent devaluation has a very limited impact on the trade balance and identified potential spill-over effects with possible adverse implications for macroeconomic stability.

Significant euroisation as the most important constraint

The most important economic constraint on greater exchange rate flexibility appears to stem from the large degree of unofficial euroisation of the Croatian financial system. By international standards, Croatia is one of the most heavily euroised countries (in terms of the share of bank deposits denominated in, or indexed to, foreign exchange). Moreover, euroisation has been persistently high despite the relatively low inflation achieved after taming the hyperinflation of the early 1990s.

As in other highly euroised economies, in order to manage exchange rate risks on their balance sheets, Croatian commercial banks denominate their lending in or index it to the euro. However, as many borrowers cannot hedge foreign exchange liabilities, the Croatian financial sector faces significant credit risks. Exchange rate depreciation could inflict losses on the balance sheet of borrowers, leading to an increase in non-performing loans and thus endangering the stability of the banking system (Šošić, Kraft 2006). Under these circumstances, the scope for greater exchange rate flexibility and, in particular, for managed depreciation appears quite limited for the time being.

External imbalances and economic policies - some conclusions

Overall, although the current external debt situation does not yet seem to indicate any immediate serious debt problem, vulnerability has nonetheless increased and continuation of past foreign debt dynamics does not appear sustainable. The widening of the current account deficit has been driven largely by strong capital inflows and investment and may be attributed to normal transition and catching-up effects. Labour productivity per person employed grew by around 3.3% on average over the period 2000-2005, more than twice the EU-25 average but lower than in some of Croatia's faster growing peers. At the same time, fiscal policy has, on average, added significantly to the savings/investment gap of the economy. The current account deficit is likely to remain in the present range or even widen further in the event of continued net capital inflows supported by expectations of catching

up and EU accession in the not too distant future. Therefore, the dynamics of foreign debt and external balances warrant close monitoring and a set of appropriate policies directed at lifting growth and productivity.

Fiscal policy remains the most powerful tool for addressing external vulnerability, as the scope for greater discretion over monetary and exchange rate policy is quite limited. Frequent requests from stakeholders for a more flexible exchange rate policy in order to address external imbalances do not appear well founded (see box above). Also, the strategy of reducing the government's share in external debt by expanding domestic borrowing may not automatically lead to lower current account deficits and foreign indebtedness, as recent experience in Croatia suggests. The size of the general government deficit plays a key role. Therefore, fiscal adjustment needs to be continued and stepped up with a view to reducing the savings/investment gap and external vulnerability of the economy. Although the fiscal deficit partly reflects high public investment, there is nonetheless considerable scope to reform spending with benign effects on growth. State intervention in the economy remains significant and Croatia's public sector, whose expenditure amounts to almost 50% of the country's GDP, is in fact the largest among its peers. As many examples in European transition economies have shown, faster structural reforms - including tackling the unfinished agenda of restructuring and privatising enterprises - are crucial in order to strengthen competitiveness, raise potential growth and help channel capital inflows into productivity-enhancing uses.

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¹ External debt sustainability analysis undertaken by the IMF (IMF 2006) confirms that external debt dynamics are particularly sensitive to large exchange rate shocks, while interest rate shocks have relatively little effect.

² The analysis which follows needs to be treated with some caution due to statistical problems related to inconsistencies between the Croatian national accounts, balance of payments and public finance data. Moreover, the size of the general government balance in 2005 and 2006 could understate the actual impact of public finances due to the existence of sizeable quasi-fiscal activities and off-budget funds (e.g. the fund for pension debt repayment).

The *ECFIN Country Focus* provides concise analysis of a policy-relevant economic question for one or more of the EU Member States. It appears fortnightly.

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