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## **Croatia: sky-rocketing foreign debt**

GDP growth lost momentum in the third quarter of 2003 (slowing down to 3.9%) mainly due to lower pace of growth of household consumption; the average rate for the first nine months of the year was 4.6%. Investment activities remained strong (+18.5%), due to motorway and housing projects, whereas government consumption growth was again negative. Thus, for the year as a whole, wiiw expects GDP to grow at some 4.3%. In line with overall developments industrial production growth slowed down gradually in the course of the year. Output of manufacturing rose by 4.5%, with publishing and printing, manufacture of fabricated metal products and manufacture of electrical machinery and apparatus registering the highest growth rates.

Retail trade growth decelerated steadily, to just 3.8% in real terms in the period January–November, as against a 12.5% increase in 2002. This was mainly a consequence of the credit squeeze imposed by the National Bank at the beginning of the year. Retail price inflation increased by 1.5% on average in 2003, the lowest value since the country gained independence. In its first session the new government fulfilled one of its election commitments and decided to reduce the VAT from currently 22% to 20%. The new regulation will become effective from 1 January 2005 as some amendments to the law still have to undergo the parliamentary procedure. Following the Slovak example, the introduction of a uniform 20% tax rate has been announced, to come into force in 2006.

The relatively high GDP growth has had little lasting impact on the creation of new jobs over recent years. Thanks to stricter registration criteria and active labour market policy measures, the number of registered unemployed fell until September, but started to increase again thereafter. However, the final figure for December 2003 indicates a remarkable improvement against December 2002, with the jobless rate down to about 19% from almost 21%. Nevertheless, the rate remains one of the highest among the more advanced transition countries.

Altogether Croatia's external position has deteriorated substantially in the course of 2003. Foreign trade performed once again disappointingly. With imports up by some 10% in euro terms, exports grew by only 6%, resulting in a record trade deficit. The coverage of imports by exports was just 44%. Thanks to a remarkable increase in trade with Italy – Croatia's most important trading partner – trade with the EU developed above average, whereas trade with the successors of former Yugoslavia remained below expectations. Despite the high deficit in commodity trade, the current account may close with a lower deficit than in 2002, when it stood at 8.5% of GDP according to the latest revisions. The improved 2003

result is mainly due to significantly higher earnings from tourism – in the third quarter alone they were more than double than a year earlier.

Croatia's main concern, however, is its soaring foreign indebtedness. According to the Minister of Finance the country's foreign debt reached an estimated USD 22.8 billion by December 2003, which is nearly 50% more than by the end of 2002 – and accounts for more than 80% of the GDP. Almost one third of the debt increase expressed in US dollar is to be attributed to the exchange rate adjustment (about 70% of total debt is denominated in euro). The major part of the debt increase stems from banks borrowing from parent banks abroad, followed by the state and companies. The 2004 debt service is estimated at USD 3.7 billion; the bulk of it falls due in the second half of the year. Most of the debt service will have to be borne by enterprises, about one third by the state and only a minor share by banks; the latter share is projected to increase in the coming two years. In 2004 the National Bank will be focusing on a further reduction of the current account deficit and the slowing down of external borrowing. In accordance with the IMF the Bank has announced to eliminate administered credit ceilings and replace them by a more orthodox monetary policy framework, by starting open market operations in the second half of 2004.

FDI inflows totalled USD 1.2 billion during the first nine months of 2003, which is significantly more than in the same period a year earlier (USD 680 million). Out of this, more than half relates to retained and/or reinvested profits (e.g. in the cases of Croatian Telekom, Pliva and banks). As the partial sale of the oil company INA to the Hungarian MOL, worth USD 505 million, is still excluded from that amount (the transaction materialized only in the final quarter of the year), the full year 2003 will register a record FDI inflow. Croatian investments abroad (USD 42 million) were mainly concentrated on projects in Bosnia and Herzegovina as well as in Serbia and Montenegro.

The fiscal outcome of 2003 was subject to embittered debates between representatives of the new and old governments. According to Mr. Suker, the new Minister of Finance, the consolidated general government closed with a 6.9% deficit relative to the GDP whereas his predecessor Mr. Crkvenac insists on the deficit being in line with the targeted 4.5% agreed upon with the IMF. Meanwhile these debates have been suspended to wait for the actual final results. Discussions on the 2004 budget – aiming at a 'further reduction' of the deficit – will start from mid-February.

Following the parliamentary elections in November, a new centre-right government, headed by Ivo Sanader from the Croatian Democratic Union, was approved on 24 December 2003. It is supported by most representatives of the ethnic minorities, pensioners, the peasants party and the Liberal Party (HSLs). In view of the main strategic goals of the new government – EU and NATO membership – the new prime minister announced to speed up reforms and fulfil the conditions for accession. Croatia submitted

its application for EU membership in February 2003, aspiring to enter the EU together with Bulgaria and Romania in 2007. Croatia expects a positive opinion from the Commission in spring and gaining the candidate status by June 2004. Thus negotiations on accession could start in late 2004 or early 2005. One of the preconditions set by the Union is Croatia's willingness to fully cooperate with the International Tribunal in the Hague; other requirements the country has to meet are the return of refugees, judicial reforms, but also resolving its protracted territorial disputes with Slovenia over their common sea border. In contrast to the government's ambitions of an early EU entry, Enlargement Commissioner Verheugen has recently stated that 'the government should not have too high expectations to join the EU in 2007'.

The weakening of Croatia's economic performance observed in the final quarter of 2003 will continue during the first months of 2004: wiiw expects GDP growth to slow down to about 3% as a consequence of the further dwindling of private consumption. Investment activities are expected to remain strong due to the motorway construction programmes. The current account deficit will remain at high levels, however, credit restrictions should help to lower imports and consequently reduce the trade deficit. Substantial improvements on the labour market are not in sight. The National Bank will continue its policy of price and exchange rate stabilization, while details of the new government's policy priorities will be known only in the coming weeks.

Table HR

## Croatia: Selected Economic Indicators

	1997	1998	1999	2000	2001	2002	2003 <sup>1)</sup>	2004 forecast	2005 forecast
Population, th pers., mid-year <sup>2)</sup>	4573	4501	4554	4437	4437	4443	.	.	.
Gross domestic product, HRK mn, nom.	123811	137604	141579	152519	165640	176429	186800	196600	206500
annual change in % (real)	6.8	2.5	-0.9	2.9	4.4	5.2	4.3	3.2	3.5
GDP/capita (EUR at exchange rate)	3891	4284	4102	4502	4998	5361	5570	.	.
GDP/capita (EUR at PPP - wiiw)	7130	7570	7510	8050	8700	9210	.	.	.
Gross industrial production <sup>3)</sup>									
annual change in % (real)	6.8	3.7	-1.4	1.7	6.0	5.4	4.1	3.5	3
Gross agricultural production									
annual change in % (real)	4.0	10.2	-3.5	-10.0	8.4	7.4	.	.	.
Goods transport, public, mn t-kms <sup>4)</sup>	203428	170107	146302	143839	142265	139313	102681	I-HX	.
annual change in %	-4.6	-16.4	-14.0	-1.7	-1.0	-2.1	0.9	I-HX	.
Gross fixed capital form., HRK mn, nom.	29935.6	32065.6	33025.0	33280.9	36984.2	43674.0	.	.	.
annual change in % (real)	26.4	2.5	-3.9	-3.8	7.1	10.1	17.5	10	7
Construction industry, hours worked <sup>3)</sup>									
annual change in % (real)	16.7	0.7	-7.7	-9.1	3.6	12.8	22.8	I-XI	.
Dwellings completed, units	12516	12557	12175	12187	18088	19549	.	.	.
annual change in %	-0.9	0.3	-3.0	0.1	48.4	8.1	.	.	.
Employment total, th pers., average <sup>5)</sup>	1310.9	1384.8	1364.5	1341.0	1348.3	1359.0	1359.8	.	.
annual change in % <sup>5)</sup>	-1.4	0.4	-1.5	-1.7	0.5	0.8	0.1	.	.
Employees in industry, th pers., average	319.7	308.9	299.5	291.9	287.2	281.0	273.5	.	.
annual change in %	-6.4	-3.4	-3.0	-2.5	-1.6	-2.2	-2.6	.	.
Reg. unemployed, th pers, end of period	287.1	302.7	341.7	378.5	395.1	366.2	318.7	.	.
Reg. unemployment rate in %, end of period	17.6	18.1	20.4	22.3	23.1	21.3	19.1	18.5	18
LFS - unemployment rate in %, average	9.9	11.4	13.6	16.1	15.9	14.8	14.0	14	13.5
Average gross monthly wages, HRK	3668	4131	4551	4869	5061	5366	5608	I-XI	.
annual change in % (real, net)	12.3	6.0	10.1	3.4	1.6	3.1	3.9	I-XI	.
Retail trade turnover, HRK mn	34736.1	.	.	.	.	.	.	.	.
annual change in % (real)	14.9	0.1	-3.5	10.0	9.5	12.5	3.8	I-XI	.
Retail prices, % p.a.	3.6	5.7	4.2	6.2	4.9	2.2	1.5	2	1.5
Producer prices in industry, % p.a.	2.3	-1.2	2.6	9.7	3.6	-0.4	1.9	.	.
Central government budget, HRK mn <sup>6)</sup>									
Revenues	33846	43809	46356	44636	53504	69869	61273	I-X	.
Expenditures	35006	42552	48879	50744	57813	73370	65770	I-X	.
Deficit (-) / surplus (+)	-1160	1257	-2523	-6108	-4309	-3501	-4497	I-X	.
Deficit (-) / surplus (+), % GDP	-0.9	0.9	-1.8	-4.0	-2.6	-2.0	.	.	.
Money supply, HRK mn, end of period									
M1, Money	13731	13531	13859	18030	23704	30870	33889	.	.
Broad money	50742	57340	56659	73061	106071	116142	128893	.	.
Discount rate % p.a., end of period	5.9	5.9	7.9	5.9	5.9	4.5	4.5	.	.
Current account, EUR mn	-2224.0	-1295.0	-1312.0	-498.0	-810.0	-2025.0	-1500	-1300	-1200
Current account in % of GDP	-12.5	-6.7	-7.0	-2.5	-3.7	-8.5	-6.1	-5.1	-4.5
Gross reserves of NB excl. gold, EUR mn	2303.7	2400.2	3012.6	3783.2	5333.6	5651.3	6553.8	Nov	.
Gross external debt, EUR mn	6760.7	8254.3	9937.2	11865.2	12830.6	14797.5	17987.2	Nov	.
Exports total, fob, EUR mn <sup>7)</sup>	3665.8	4046.2	4027.3	4818.0	5210.4	5187.3	5500	5700	5900
annual growth rate in %	1.8	10.4	-0.5	18.9	8.1	-0.4	6	4	4
Imports total, cif, EUR mn <sup>7)</sup>	8059.7	7476.9	7324.1	8588.5	10232.4	11324.8	12400	13100	13900
annual growth rate in %	29.6	-7.2	-2.0	16.8	19.1	10.7	10	6	6
Average exchange rate HRK/USD	6.16	6.36	7.11	8.28	8.34	7.86	6.70	.	.
Average exchange rate HRK/EUR (ECU)	6.96	7.14	7.58	7.63	7.47	7.41	7.56	7.7	7.8
Purchasing power parity HRK/USD, wiiw	3.46	3.71	3.80	3.90	3.96	3.96	3.97	.	.
Purchasing power parity HRK/EUR, wiiw	3.80	4.04	4.14	4.27	4.34	4.29	4.26	.	.

Notes: 1) Preliminary. - 2) From 2000 according to census March 2001. - 3) Enterprises with more than 20 employees. - 4) From 2001 new methodology. - 5) Including persons employed at the Ministry of Defence and Ministry of Internal Affairs. - 6) Methodological changes in June 2001 and January 2002 with respect to the stepwise inclusion of extrabudgetary funds. - 7) From 2000 new method of statistical processing. Converted from the national currency to EUR at the official exchange rate.

Source: wiiw Database incorporating national statistics; wiiw forecasts.