The Vienna Institute for International Economic Studies

Croatia: Growth Slowdown and Policy Alternatives

Final Report

prepared by

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Growth

During 2004 Croatia's growth lost momentum from quarter to quarter, and the GDP was up by 3.8% for the year as a whole. The deceleration went hand in hand with a slowdown of (public) investment growth to only 4.4% year on year compared with almost 17% in 2003. Household consumption growth continued its downward trend and government consumption fell for the fifth consecutive year. The weak investment performance in turn resulted in a remarkable slowdown of construction activities. On the other hand, the weakening of domestic demand could be partly offset by rising external demand. From a comparative perspective Croatia's GDP grew less than in any of the new EU member states (NMS) in 2004 and was only higher than in Macedonia if compared with the Southeast European (SEE) countries. Developments during the first months of 2005 point to a further cooling down of Croatia's economy.

In order to show the importance of changes in the individual GDP components for GDP growth properly, we use the contributions of those components to the overall GDP growth rates. As can be seen from Table 1, over the past couple of years these contributions had somewhat changed in Croatia. In the year 2000 consumption, investment and foreign trade all contributed positively to GDP growth. In the three following years it was only consumption and investment that drove GDP growth. At the same time the contribution of foreign trade turned negative. Between 2000 and 2004 the contribution of consumption was only related to private consumption, while the government contributed negatively to GDP growth over the whole period. The relatively strong expansion of private consumption was achieved at the cost of unfavourable changes in foreign trade. In 2004 the contribution of investment slowed markedly and foreign trade contributed positively to GDP growth for the first time since 2000. Increasing household consumption was made possible through rising wages but also as a consequence of high household lending.

A comparison with the new EU member states and candidate countries shows that, though the sources of growth are rather uneven across the region, it was total consumption that contributed significantly to overall GDP growth in all countries over the period 2000-2004. In a number of countries (the Czech Republic, Slovenia, Estonia, Latvia, Bulgaria and Romania) also gross fixed investment contributed steadily to GDP growth over the whole period. Surprisingly, the contributions of foreign trade were characterized by remarkable swings across individual countries. In the Czech Republic foreign trade contributed negatively to GDP growth from 2000 onwards, while Poland is the only country revealing positive contributions over the entire period. All other countries show a changing

Table 1

Contributions (percentage points) to the GDP growth rates

	2000	2001	2002	2003	2004
Czech Republic					
GDP growth rate (%)	**3.9**	**2.6**	**1.5**	**3.7**	**4.0**
Consumption	1.6	2.2	2.5	3.6	0.6
Gross fixed investm.	1.5	1.6	1.1	1.5	2.9
Trade Balance	-1.1	-2.2	-2.7	-1.5	-0.5
Hungary					
GDP growth rate (%)	**5.2**	**3.8**	**3.5**	**3.0**	**4.0**
Consumption	3.2	4.1	6.3	5.6	1.7
Gross fixed investm.	1.9	1.2	2.0	0.9	-2.2
Trade Balance	0.5	2.1	-2.1	-2.6	0.8
Poland					
GDP growth rate (%)	**4.0**	**1.0**	**1.4**	**3.8**	**5.3**
Consumption	2.0	1.4	2.2	1.9	2.2
Gross fixed investm.	0.7	-2.2	-1.3	-0.1	1.0
Trade Balance	1.2	2.9	0.7	1.8	1.1
Slovenia					
GDP growth rate (%)	**3.9**	**2.7**	**3.3**	**2.5**	**4.6**
Consumption	0.7	2.0	0.5	2.0	2.2
Gross fixed investm.	0.2	1.2	0.9	1.8	2.0
Trade Balance	2.4	1.8	1.0	-2.4	-0.3
Slovak Republic					
GDP growth rate (%)	**2.0**	**3.8**	**4.6**	**4.5**	**5.5**
Consumption	-0.1	3.5	4.0	0.2	2.1
Gross fixed investm.	-2.0	3.6	-0.2	-0.3	0.6
Trade Balance	1.9	-3.7	-0.1	6.5	-0.8
Estonia					
GDP growth rate (%)	**7.8**	**6.4**	**7.2**	**5.1**	**6.2**
Consumption	5.1	3.9	7.1	4.5	4.2
Gross fixed investm.	3.9	3.7	5.2	1.8	2.9
Trade Balance	-2.3	-2.5	-3.1	-6.2	0.7
Latvia					
GDP growth rate (%)	**6.9**	**8.0**	**6.4**	**7.5**	**8.5**
Consumption	3.1	5.2	5.0	5.8	6.8
Gross fixed investm.	2.4	2.8	3.5	2.9	5.4
Trade Balance	3.0	-4.0	-0.2	-4.6	-5.4
Lithuania					
GDP growth rate (%)	**3.9**	**6.4**	**6.8**	**9.7**	**6.7**
Consumption	4.8	2.4	4.2	8.6	7.1
Gross fixed investm.	-1.9	2.5	2.2	2.9	2.7
Trade Balance	1.8	0.5	-0.1	-2.4	-5.3
Bulgaria					
GDP growth rate (%)	**5.4**	**4.1**	**4.9**	**4.3**	**5.7**
Consumption	4.7	4.0	3.2	5.7	4.2
Gross fixed investm.	2.6	4.3	1.9	3.1	3.0
Trade Balance	-3.3	-5.1	0.5	-7.1	-3.0
Romania					
GDP growth rate (%)	**2.1**	**5.7**	**5.0**	**4.9**	**8.3**
Consumption	1.2	5.6	2.3	6.0	8.9
Gross fixed investm.	1.2	2.3	1.8	2.2	2.2
Trade Balance	-3.8	-5.2	0.6	-5.3	-3.1

(Table 1 contd.)

Table 1 (contd.)

Croatia					
GDP growth rate (%)	**2.9**	**4.4**	**5.2**	**4.3**	**3.8**
Consumption	2.1	1.1	4.1	2.5	2.3
Private	2.5	2.7	4.5	2.5	2.4
government	-0.4	-1.6	-0.4	-0.1	-0.1
Gross fixed investm.	-0.9	1.5	2.7	4.0	1.2
Trade Balance	3.2	-1.4	-4.2	-1.5	0.5
exports of goods & serv.	5.1	3.7	0.6	4.6	2.6
imports of goods & serv.	-1.9	-5.1	-4.8	-6.2	-2.1

Source: Eurostat.

importance of foreign trade contributions from year to year. In 2004 foreign trade reduced real GDP growth in most new member countries and in the candidate countries, except Hungary, Poland, Estonia and Croatia – where it added to growth relatively little. In other words, GDP growth in all countries under consideration was driven by domestic demand everywhere in 2004 (for more details see Havlik, Podkaminer, Gligorov et al., 2005).

Industrial production decelerated from quarter to quarter. This reduced the year-on-year growth rate to 3.7% in 2004, compared to 4.1% in 2003 (Table 2). Within manufacturing, reporting slightly higher than average growth, the most favourable results were achieved by 'other transport equipment' (ships), machinery and equipment, chemicals and chemical products, manufacturing of wood and wood products, and publishing and printing. Labour-intensive industries such as textiles and manufacturing of wearing apparel, but also office machinery, computers, television and communication equipment, all suffered severe output declines. The output increase in Croatia was only modest compared to the NMS where industrial production grew by 10% on average in 2004; among the SEE countries Croatia performed only better than Macedonia and Albania. Overall, industrial production in 2004 was 77% of what it had been in 1990. This compares well with the situation in most SEE countries, but is diverging significantly from the developments observed in the NMS-5 (Czech Republic, Hungary, Poland, Slovakia, Slovenia), where all countries but Slovenia had exceeded the pre-transition level by far. First results for 2005 indicate a further and even more pronounced slowdown of industrial output growth: in the first quarter of the year industrial production grew by a mere 0.2%. The sectoral trends prevailing in 2004 continued or even deteriorated.

Trade

Retail trade turnover was weaker than in the last couple of years and increased by just 2.4% in real terms in 2004 due to a noticeable decline of car sales. Excluding the sales of motor vehicles, retail trade was up by 5.6%. In the first quarter of 2005 retail trade turnover grew by a meagre 0.7% in real terms as against the same 2004 period. Though somewhat

Table 2

Croatia: Selected economic indicators

	1998	1999	2000	2001	2002	2003	2004 [1]	2005 forecast	2006 forecast
Population, th pers., mid-year [2]	4501	4554	4437	4437	4443	4442	4440	.	.
Gross domestic product, HRK mn, nom.	137604	141579	152519	165640	179390	193067	207082	219700	231900
annual change in % (real)	2.5	-0.9	2.9	4.4	5.2	4.3	3.8	3.5	3.5
GDP/capita (EUR at exchange rate)	4284	4102	4502	4998	5451	5747	6222	.	.
GDP/capita (EUR at PPP - wiiw)	7470	7450	8110	8640	9300	9720	10390	.	.
Gross industrial production [3]									
annual change in % (real)	3.7	-1.4	1.7	6.0	5.4	4.1	3.7	2.5	3
Gross agricultural production									
annual change in % (real)	10.2	-3.5	-10.0	8.5	7.7	-15.9	.	.	.
Construction industry, hours worked [3]									
annual change in % (real)	0.7	-7.7	-9.1	3.6	12.8	22.8	2.0	.	.
Consumption of households, HRK mn, nom.	81067	81546	89637	98054	107427	113396	120312	.	.
annual change in % (real)	-0.6	-2.9	4.2	4.5	7.6	4.1	3.9	3	3
Gross fixed capital form., HRK mn, nom.	32066	33025	33281	36984	44114	53168	57141	.	.
annual change in % (real)	2.5	-3.9	-3.8	7.1	12.0	16.8	4.4	5	4
LFS - employed persons, th, avg.	1544	1492	1553	1469	1528	1537	1563	.	.
annual change in %	-3.1	-3.4	4.1	-5.4	4.0	0.6	1.7	.	.
Reg. employees in industry, th pers., avg.	308.9	299.5	291.9	287.2	281.0	282.6	276.4	.	.
annual change in %	-3.4	-3.0	-2.5	-1.6	-2.2	0.6	-2.2	.	.
LFS - unemployed, th pers., average	199.0	234.0	298.0	277.0	266.0	256.0	253	.	.
LFS - unemployment rate in %, average	11.4	13.6	16.1	15.9	14.8	14.3	13.8	13.5	13
Reg. unemployment rate in %, end of period	18.1	20.4	22.3	23.1	21.3	19.1	18.7	18.5	18
Average gross monthly wages, HRK	4131	4551	4869	5061	5366	5623	5985	.	.
annual change in % (real, net)	6.0	10.1	3.4	1.6	3.1	3.8	3.7	.	.
Consumer prices, % p.a. [4]	5.7	4.2	6.2	4.9	1.7	1.8	2.1	2.5	2
Producer prices in industry, % p.a.	-1.2	2.6	9.7	3.6	-0.4	1.9	3.5	2	.
General governm.budget, IMF-def., % GDP									
Revenues	51.1	48.4	46.2	44.7	45.2	44.9	.	.	.
Expenditures	54.6	56.6	52.7	51.5	50.0	49.5	.	.	.
Deficit (-) / surplus (+), % GDP	-3.5	-8.2	-6.5	-6.8	-4.8	-6.3	-4.9	-4	.
Public debt in % of GDP	.	42.3	48.9	50.3	50.4	51.7	53.2	54	55
Discount rate % p.a., end of period	5.9	7.9	5.9	5.9	4.5	4.5	4.5	.	.
Current account, EUR mn [5]	-1297	-1318	-504	-787	-2034	-1757	-1276	-1300	-1400
Current account in % of GDP	-6.7	-7.1	-2.5	-3.5	-8.4	-6.9	-4.6	-4.4	-4.6
Gross reserves of NB excl. gold, EUR mn	2400.2	3012.6	3783.2	5333.6	5651.3	6554.1	6436.2	.	.
Gross external debt, EUR mn	8254.3	9937.2	11865.2	12827.6	15054.8	19810.6	22675.4	.	.
FDI inflow, EUR mn [5]	833	1381	1178	1746	1196	1779	871	.	.
FDI outflow, EUR mn [5]	88	53	4	173	572	93	254	.	.
Exports of goods, BOP, EUR mn [5]	4084	4124	4951	5314	5313	5572	6602	7100	7500
annual growth rate in %	14.8	1.0	20.1	7.3	0.0	4.9	18.5	8	6
Imports of goods, BOP, EUR mn [5]	7713	7219	8423	9892	11309	12546	13327	14100	14800
annual growth rate in %	-7.3	-6.4	16.7	17.4	14.3	10.9	6.2	5	5
Exports of services, BOP, EUR mn [5]	3534	3494	4413	5453	5927	7680	7816	.	.
annual growth rate in %	-0.2	-1.1	26.3	23.6	8.7	29.6	1.8	.	.
Imports of services, BOP, EUR mn [5]	1683	1969	1975	2176	2563	2633	2910	.	.
annual growth rate in %	-3.9	17.0	0.3	10.2	17.8	2.7	10.5	.	.
Average exchange rate HRK/USD	6.36	7.11	8.28	8.34	7.86	6.70	6.04	.	.
Average exchange rate HRK/EUR (ECU)	7.14	7.58	7.63	7.47	7.41	7.56	7.50	7.5	7.6
Purchasing power parity HRK/USD, wiiw	3.55	3.65	3.74	3.80	3.85	3.89	3.99	.	.
Purchasing power parity HRK/EUR, wiiw	4.09	4.18	4.24	4.32	4.34	4.47	4.49	.	.

Notes: 1) Preliminary. - 2) From 2000 according to census March 2001. - 3) Enterprises with more than 20 employees. - 4) Up to 2001 retail prices, % p.a. - 5) wiiw calculated from USD until 2002.

Source: wiiw Database incorporating national statistics; IMF; wiiw forecasts.

higher than a year earlier, inflation remained at low levels in 2004: consumer prices increased by 2.1% on average, in December by 2.7% year on year. Fuelled by rises of food prices and most recently by increasing oil prices, inflation rose significantly during the first months of 2005, with consumer price rises reaching the highest level in the last couple of years – 3.9% in March 2005 year on year.

Labour market

Depending on the respective data source, labour market developments show a diverging picture. According to registration figures, employment remained stagnant in 2004, while unemployment fell below 19%. However, unemployment started to rise from August and totalled – after some seasonal declines in February and March – 320 thousand persons or an 18.7% unemployment rate in April 2005, a higher level than in the same month a year earlier. Labour force survey (LFS) data for 2004 indicate a decrease in unemployment (below 14%). The same data set points to a 1.7% increase in employment as compared to the first half of 2003. Data obtained from the Croatian Pension Insurance Institute (CPII) also suggest some rise (1.3%) in employment, based on the number of insured persons. Compared with the new EU member states, Croatia belongs to the group of high-unemployment countries, like Poland, if measured by registration data. Based on labour force survey data it ranges among the medium-unemployment countries, like the Baltic States and Bulgaria (Table 3). Structural indicators of unemployment show some improvement in the first half of 2004, but the situation remained worrisome in most cases. Youth unemployment is more than twice as high as both the average national rate and the EU-15 average and is exceeding the rates of most of the new member states, except Poland. Unemployment remained high during the first months of 2005 (19.2% in March) reflecting the deceleration of economic activities.

Overall, high GDP growth over the past several years was accompanied only by moderate employment growth or even stagnation. These tendencies are apparent in most of the new EU member states and SEE countries as well. The relation between employment and production growth in the NMS has been disappointing, since even in the periods of robust GDP growth there has been little effect on the creation of new jobs. The employment elasticity has been much below unity (see Havlik, 2005).[1] Croatia's employment rate, at 53.2% in 2003, is very low by EU standards and ranks at the lower end of the scale, only higher than in Poland and in the two candidate countries Turkey and Bulgaria (Table 4). Regarding male rates, only Bulgaria ranges below Croatia, and in the case of female employment rates, only Italy and Turkey exhibit lower values.

[1] There are differences among countries: constant employment would require GDP growth of at least 3% in Hungary, more than 4% in the Czech Republic and about 6% in Poland.

Both average real gross and net wages continued to rise and were up by 4.2% and 3.7% respectively in 2004, implying that wage growth has exceeded productivity growth.

Table 3

Unemployment rates

according to LFS (annual average) and registration data (end of period)

	1996	1997	1998	1999	2000	2001	2002	2003	2004 [1)]
Croatia									
LFS	9.9	9.9	11.4	13.6	16.1	15.9	14.8	14.3	13.8
regist	15.9	17.6	18.1	20.4	22.3	23.1	21.3	19.1	18.7
Czech Republic									
LFS	3.9	4.8	6.5	8.7	8.8	8.1	7.3	7.8	8.3
regist	3.5	5.2	7.5	9.4	8.8	8.9	9.8	10.3	9.5
Hungary									
LFS	10.0	8.8	7.8	7.0	6.4	5.7	5.8	5.9	6.1
regist	11.2	10.9	9.5	9.3	8.6	8.0	8.0	8.3	8.7
Poland									
LFS	12.3	11.2	10.6	13.9	16.1	18.2	19.9	19.6	19.3
regist	13.2	10.3	10.4	13.1	15.1	17.5	20.0	20.0	19.1
Slovakia									
LFS	11.3	11.8	12.5	16.2	18.6	19.2	18.5	17.4	18.5
regist	12.8	12.5	15.6	19.2	17.9	18.6	17.5	15.6	13.1
Slovenia									
LFS	7.3	7.4	7.9	7.6	7.0	6.4	6.4	6.7	6.3
regist	14.4	14.8	14.6	13.0	12.0	11.8	11.3	11.0	10.4
Bulgaria									
LFS	14.1	14.4	14.1	15.7	16.9	19.7	17.8	13.7	12.0
regist	12.5	13.7	12.2	16.0	17.9	17.3	16.3	13.5	12.2
Romania									
LFS	6.7	6.0	6.3	6.8	7.1	6.6	8.4	7.0	7.5
regist	6.6	8.9	10.4	11.8	10.5	8.8	8.4	7.4	6.2
EU-15									
LFS	10.2	10	9.4	8.7	7.8	7.4	7.7	8.0	8.0

Note: 1) Preliminary.

Source: wiiw Database incorporating national statistics.

Table 4

Employment rates

employed in % of working-age population 15-64

	1996	1997	1998	1999	2000	2001	2002	2003
Croatia								
Total	61.6	59.5	58.1	55.4	51.4	51.6	53.1	53.2
Male	.	.	.	.	57.4	59.0	59.8	59.9
female	.	.	.	.	45.6	44.7	46.7	46.5
Czech Republic								
Total	.	.	67.3	65.6	65.0	65.0	65.4	64.7
Male	.	.	76.0	74.0	73.2	73.2	73.9	73.1
female	.	.	58.7	57.4	56.9	56.9	57.0	56.3
Hungary								
Total	52.1	52.4	53.7	55.6	56.3	56.2	56.2	57.0
Male	59.5	59.7	60.5	62.4	63.1	62.9	62.9	63.5
female	45.2	45.4	47.2	49.0	49.7	49.8	49.8	50.9
Poland								
Total	.	58.9	59.0	57.6	55.0	53.4	51.5	51.2
Male	.	66.8	66.5	64.2	61.2	59.2	56.9	56.5
female	.	51.3	51.7	51.2	48.9	47.7	46.2	46.0
Slovak Republic								
Total	.	.	60.6	58.1	56.8	56.8	56.8	57.7
Male	.	.	67.8	64.3	62.2	62.0	62.4	63.3
female	.	.	53.5	52.1	51.5	51.8	51.4	52.2
Slovenia								
Total	61.6	62.6	62.9	62.2	62.8	63.8	63.4	62.6
Male	66.0	67.0	67.2	66.5	67.2	68.6	68.2	67.4
female	57.1	58.0	58.6	57.7	58.4	58.8	58.6	57.6
Bulgaria								
Total	54.0	54.1	53.7	51.2	50.4	49.7	50.6	52.5
Male	57.7	58.0	57.5	55.1	54.7	52.7	53.7	56.0
female	50.4	50.3	49.9	47.5	46.3	46.8	47.5	49.0
Romania								
Total	.	65.4	64.2	63.2	63.0	62.4	57.6	57.6
Male	.	71.9	70.4	69.0	68.6	67.8	63.6	63.8
female	.	59.1	58.2	57.5	57.5	57.1	51.8	51.5
EU-15								
Total	60.3	60.7	61.4	62.5	63.4	64.1	64.3	64.4
Male	70.4	70.7	71.3	72.0	72.8	73.1	72.9	72.7
female	50.2	50.8	51.6	52.9	54.1	55.0	55.6	56.1

Source: Eurostat.

Credits

In 2004 the share of household credits for the first time exceeded that of enterprises. Households accounted for 50.7% of the total credit volume, enterprises for 41.4%; the remainder was due to credits granted to medium and local government levels. Administrative measures imposed by the Croatian National Bank (CNB) to control credit growth led to a slowdown in household consumption but had no noticeable impact on enterprise borrowing.[2] In 2004 credits to the non-banking sector rose by 13.8%, of which by 18.7% to households and by 8% to enterprises – the latter figure being somewhat higher than in 2003. However, published figures for enterprises seem to be distorted and understate the availability of credits due to strong growth in leasing and in enterprise direct foreign borrowing (Kraft and Jankov, 2005).[3] About HRK 4.5 billion or 44% of the newly granted private credits accounted for housing credits.

Foreign trade

Foreign trade performed dynamically in 2004, with overall exports expanding by nearly 18% (based on customs statistics expressed in euro terms) whereas imports increased only moderately, by 6%. These developments resulted in a lowering of the foreign trade deficit. The 2004 export outcome marked the best result since 2000. Exports to and imports from the EU reported below-average growth rates, while trade with the successors of Yugoslavia, particularly Bosnia and Herzegovina and Serbia and Montenegro, speeded up significantly. A breakdown by individual industrial branches shows a strong export expansion in the case of ships and of radio, television and communication equipment. The slowdown of import growth is partially attributed to the decline in car imports after years of strong increases; below-average import growth from the EU was mainly the result of declining imports from Italy. On the other hand imports from the Yugoslav successor states and Russia expanded substantially. The turnaround in the (up to now rather weak) foreign trade sector that had been hoped for after the favourable results in 2004 did not materialize in the first months of 2005. During the first quarter of the year import growth exceeded export growth again, thus the trade balance closed with a EUR 1.6 billion deficit (by some EUR 100 million more than in the corresponding 2004 period).

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[2] *Inter alia*, the CNB introduced, at the beginning of 2003 (until the end of the year), the compulsory purchase of CNB bills if credit loans expanded at a quarterly (annual) rate higher than 4% (16%).

[3] For instance, in 2003 enterprise lending increased by 5.1%, according to available statistics. But, including the above-mentioned forms of lending and some other 'balance sheet tricks', borrowing is estimated to have expanded by about 15%.

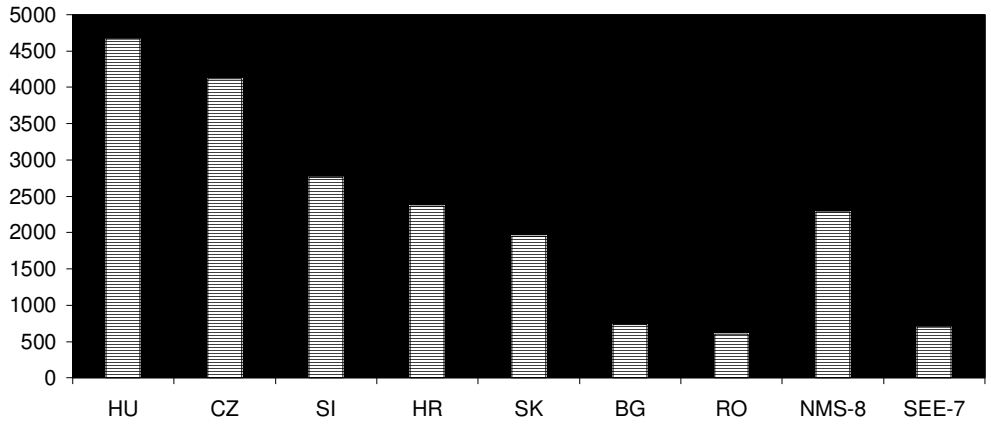
Foreign direct investment

FDI data indicate a considerable decline of inward FDI compared with a year earlier. Greenfield investments, particularly in the export-oriented manufacturing sector, still play only a minor role in Croatia. However, when it comes to FDI per capita, Croatia ranks first among the South East European countries and it compares also well with the new member EU states. In 2004 Croatia ranked fifth after Hungary, Estonia, the Czech Republic and Slovenia – even ahead of Slovakia and Poland (Figure 1). Outward FDI increased from EUR 93 million in 2003 to EUR 250 million in 2004.

Figure 1

FDI per capita, 2004

EUR



Source: wiiw Database incorporating national statistics.

Current account

The current account statistics were subject to major revisions. Accordingly in 2003 the deficit to GDP ratio was revised downwards, from 7.3% earlier to 6.9% expressed in euro terms. Thanks to a lowering of the trade deficit and a reduction of the deficit in the income balance, the current account experienced a substantial improvement in 2004, with the deficit falling to EUR 1.3 billion (from EUR 1.8 billion in 2003) or 4.6% of the GDP. Over the past several years the persistently high current account deficits have been primarily financed by rising foreign debt, totalling EUR 22.7 billion (82.1% of GDP) by the end of 2004. Last year's increase was mostly impacted by banks' and state borrowing, followed by other sectors (such as enterprises and the population). The first two months of 2005 witnessed a reversal of trends, with foreign debt felling slightly to EUR 22.5 billion.

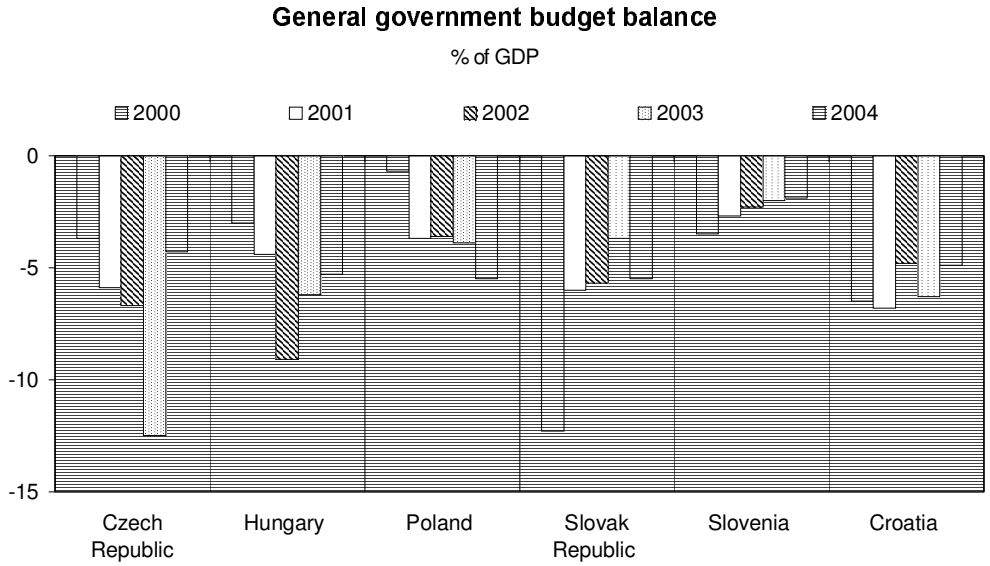
Croatia's debt service burden is expected to increase significantly in the years to come. According to the most recent projections of the Croatian National Bank, in 2005 the debt

service will amount to USD 4.1 billion, of which USD 3.6 billion in principal and USD 500 million in interest payments. Principal repayments will be highest for banks (USD 1.4 billion) followed by enterprises (USD 1.2 billion) and finally the state with liabilities worth USD 1 billion. The bulk will be due in the first and third quarters of the year.

Fiscal balance

Reducing the fiscal deficit has been one of the primary tasks of the old and new Croatian governments. In 2003 alone the deficit of the consolidated general government amounted to 6.3% of GDP. Recently published figures for 2004 put the general government deficit at HRK 10.2 billion or 4.9% relative to the GDP, which is somewhat higher than the target rate set at 4.5%. This outcome compares well with most of the new member states (except the Baltic States and Slovenia), but is substantially higher than in the SEE countries, which have reached a remarkable fiscal adjustment over the past couple of years (see Figure 2).

Figure 2



Source: wiiw Database incorporating national statistics.

The 2005 budget bill passed by the Croatian parliament in November 2004 is based on the programme elaborated with the IMF in August last year and the Pre-Accession programme adopted in November. It is aiming at a further reduction of the consolidated general government deficit to 3.7% in 2005; in the subsequent two years the deficit is envisaged to fall to 3.3% (2006) and finally to 2.9% of the GDP (2007). The 2005 budget is based on a projected 2.5% inflation rate and 4.4% GDP growth; the latter seems to be over-ambitious compared to available forecasts (from various research institutes and the EU) which range from 3.5% to 4%. Most of the budget deficit is expected to be covered by privatization receipts coming from the sale of the remaining state stakes in Croatian Telecom and in the

oil and gas company INA. According to the IMF agreement the country's authorities committed themselves to meeting at least one third of government borrowing requirements from the domestic market in 2004 and raise this share in the coming years (for a more detailed analysis of the fiscal sector see below).

Growth prospects

Results obtained for the first months of 2005 suggest a further deceleration of economic activities. wiiw expects a slowdown of Croatia's GDP growth to some 3.5% at best in both 2005 and 2006. Growth will be supported primarily by domestic demand, though (public) investment growth is expected to moderate further compared to the robust growth over the last couple of years, particularly in construction investment. Thus, growth will have to be borne primarily by private sector activities. The situation on the labour market will not change for the better: employment will grow only moderately or even stagnate, whereas the number of unemployed will remain at high levels. Despite some rise in inflation in 2004, the National Bank will adhere to its policy of stable prices and exchange rates. The current account deficits will diminish only slightly over the next two years.

Integration

EU membership negotiations – originally scheduled to start on 17 March – have been frozen as Croatia failed to fully cooperate with the UN War Criminal Tribunal in The Hague. Contrary to earlier announcements by Croatian officials that the country may join the EU already in 2007, the current wording is that Croatia aims to conclude accession talks by that date. The president of the European Commission stated that he 'hopes Croatia will become an EU member in November 2009'. Accession talks with Croatia will be conducted in the framework of 35 chapters (not 31 as during the previous enlargement round) as some policy areas will be split. The Stabilization and Association Agreement (SAA) signed between the EU and Croatia in 2001 came into force on 1 February 2005. Croatia's first pre-accession programme was adopted by the government by the end of November, focusing *inter alia* on reforms of public financing (reduction of the fiscal deficit, improvement of fiscal transparency etc.) and on structural reforms, relating to privatization, agricultural policy or the social security and health care systems.

II. Fiscal sector

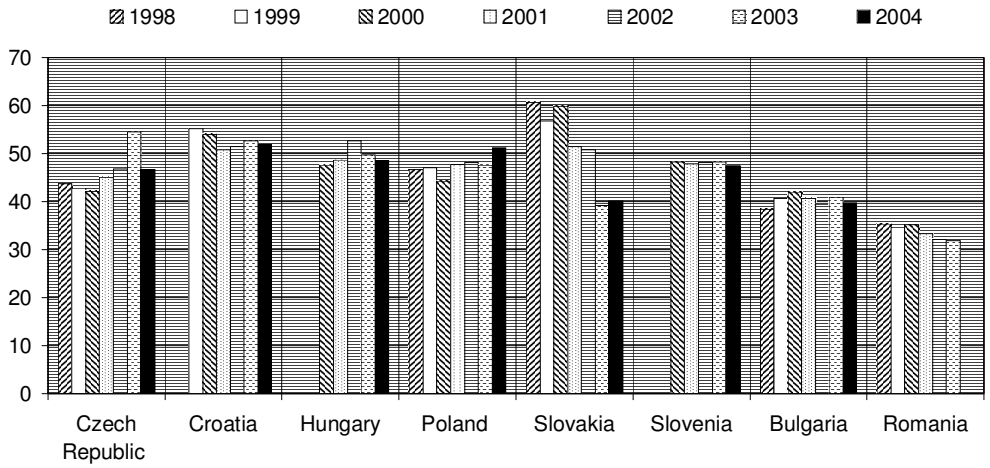
Information on Croatia's fiscal sector is lacking transparency due to several methodological changes in the data compilation over recent years. To illustrate the problem, it is for example impossible to figure out the actual size of the public sector in Croatia since time series are inconsistent and/or incomplete: e.g., available 2003 data on the general

government expenditures measured as a share of GDP vary between 49.5% and 52.7%; similar discrepancies are found for other years (for more details on data provided by different sources see Appendix). This makes an assessment of the actual situation difficult.

Irrespective of these differences, Croatia has one of the largest public sectors if compared to the new EU member states or the EU-15. Expenditures as a share of GDP are among the highest if compared to these countries (Figure 3).

Figure 3

General government expenditures as a share of GDP, 1998-2004



Source: wiiw Database incorporating national statistics; Croatia: Ministry of Finance, IMF.

When it comes to the expenditure structure, Croatia again shows a different picture compared to the new EU member states (Table 5). The public sector still spends a high portion on public sector wages and salaries, and on subsidies and transfers as compared to other countries (for more details on subsidies see below).

The most important category of general government expenditures is social benefits, the share of which accounted for about 43.5% of total current spending in 2004, slightly more than a year earlier. Compensation of employees (including wages and salaries and social contributions) makes up some 27%, or 23% if looking at public sector wages and salaries only – both values were by about one percentage point lower than in 2003. The third most important item of expenditures is the use of goods and services (almost 10%, declining share). Categories revealing a growing importance in 2004 are current spending on interest, subsidies and other expenditures. In 2004, budgetary revenues were lower than anticipated by the revised budget, mainly due to lower earnings from tax collection, particularly from taxes on goods and services (VAT), but also from excise taxes. Total expenditures developed in line with the expected outcome in the revised budget.

Table 5

General government revenues and expenditures as a share of GDP, 1998-2003

	Total revenue	Non-tax revenue	Tax revenue	Total expenditure	Current expend.	Wages & salaries	Goods & services	Subsidies and transfers	Capital expend.
Croatia	**46.6**	**4.0**	**42.4**	**52.5**	**45.3**	**11.8**	**11.3**	**20.1**	**6.5**
Hungary	43.3	4.6	38.8	47.6	43.0	11.3	7.1	19.9	4.5
Czech Republic	38.9	2.6	36.3	43.9	38.6	3.5	5.2	28.9	5.4
Poland	38.5	4.4	34.1	42.9	40.0	11.1	6.3	19.7	2.9
Slovakia	38.8	5.2	33.5	42.8	37.9	8.3	5.2	19.8	4.9
Slovenia	41.0	2.5	38.3	42.7	38.6	9.5	8.0	18.9	4.2
Macedonia	33.7	2.1	31.5	36.2	33.7	7.9	4.7	19.4	2.6
Bulgaria	37.0	7.9	29.1	34.1	30.2	4.5	7.0	15.5	4.0
Romania	30.3	1.9	28.5	34	30.5	5.0	7.5	14.4	3.2
Euro area	47.3	5.1	42.2	49.2	45.2	10.6	.	27.8	4.0

Source: IMF.

State aid

Information on state aid granted by Croatia is incomplete since the state aid allocation system is not fully in operation yet. Provisional data indicate that the overall level of state aid amounted to 3.2% of GDP in 2003.[4] This was significantly higher than 0.57% and 1.42% in the EU-15 and the NMS-10, respectively, in 2003 (European Commission, 2004 and 2005).[5] Though there were large disparities among the NMS – values ranged between 2.8% in the Czech Republic and 0.1% in Estonia – the reported level for Croatia was higher than in any other country.

By signing the Association Agreement with the EU, Croatia committed itself to harmonizing its state aid system in conformity with the *acquis*. This means 'starting a process of reducing the general level of state aid and shifting the emphasis from supporting individual enterprises or sectors towards tackling horizontal objectives of Community interest' (European Commission, 2005, p. 4).[6] In the case of Croatia the share of horizontal aid was almost negligible over the past few years and accounted for 6.9% of total aid in 2003, which is extremely low compared to the EU-15, where the portion of horizontal aid

[4] Croatian figures on state aid are based on the 2004 Annual Report of the Croatian Competition Agency. In contrast to EU data, Croatian figures include aid on agriculture and transport, which consequently raises the aid to GDP ratio. Excluding these two items would reduce the state aid ratio from 3.2% to 1.4% in 2003 – still higher than the EU-15 average, but equalling the NMS average value.

[5] EU-15 data refer to 2003, NMS-10 data refer to the annual average of the 2000-2003 period. If one excludes measures which are either being phased out under transitional agreements or limited in time, the portion of state aid in the NMS would drop to 0.67% of the GDP.

[6] Horizontal aid is considered as being targeted to recognized market failures and as being less distortive than sectoral and *ad hoc* aid. Considered as horizontal objectives are: research and development, safeguarding the environment, energy saving, support to SMEs, employment creation, or the promotion of training and aid for regional development.

accounted for 79%. Compared to the NMS, where the respective share was given at 22% over the 2000-2003 period, the difference was much smaller. Croatian specific sector aid is, apart from transport (not an EU category), mainly directed towards shipbuilding[7], 'other sectors', tourism and financial services (the two latter are playing a much more important role in the NMS). In general, comparisons with the NMS are difficult as the state aid patterns reflect first of all the country-specific situation.

Functional classification

A breakdown of general government expenditures by economic function again shows that social spending is – as in other countries – the by far most important expenditure item in Croatia (Tables 6a and 6b).[8] Its portion as a percentage of GDP is about one percentage point lower than in Slovenia and two percentage points below the EU-15 level, but slightly higher than in Hungary or in Slovakia.[9]

Table 6a

Central government budget: functional classification, 2003

in % of GDP

	HR	EE	HU	SK
Total expenditure	41.0	27.5	34.5	25.8
1. General public services	1.8	3.4	7.4	4.3
2. Defence affairs and services	2.1	1.8	1.3	1.8
3. Public order and safety affairs	2.7	2.7	1.9	1.9
4. Education affairs and services	3.5	4.0	4.2	4.1
5. Health affairs and services	6.0	2.3	2.1	3
6. Social security and welfare affairs and services	17.3	8.9	7.1	4.4
7. Housing and community amenity affairs and services	1.1	0.0	0.4	0.5
8. Recreational, cultural and religious affairs	0.6	1.2	1.6	0.7
9. Economic affairs	3.2	2.9	5.1	4.7
10. Environment	.	0.4	0.3	0.4
Expenditures not classified by major group	2.6	.	.	.

Source: Ministry of Finance, Eurostat, own calculations.

Another significant item is health, the portion of which is similar to that in the EU-15, but again higher than in the other countries under comparison, whereas government spending on education was generally lower. Despite declining over time, Croatia still spends a higher

[7] In 2003 state aid for Croatian shipbuilding amounted to EUR 131 million versus EUR 685 million in the EU-15 as a whole (of which more than half accounted for Germany, followed by France and Denmark).

[8] The Ministry of Finance offers data on the functional classification only on the central government level; the data on the general government presented here are calculated by the IMF and do not exist on a regular base.

[9] Eurostat data on the functional classification of general government expenditures are available only for Estonia, Hungary and Slovakia.

portion on defence affairs and public order and safety than the EU-15 and the new member states. In 2003 that portion was close to 5%, while the respective value in the EU-15 and Hungary was 3.4% each. Only Estonia reports a similar share as Croatia.

The high public expenditures have been accompanied by relatively high fiscal deficits, as can be seen from Figure 2 above. This is especially true after the crisis of the late 1990s. Since then, the reform of public spending has become one of the main economic policy issues.

Table 6b

General government budget: functional classification, 2003

in % of GDP

	HR 2001	EE	HU	SK	SI
Total expenditure	50.0	35.8	49.8	39.3	48.1
1. General public services	3.5	3.2	8.1	5.2	8.5
2. Defence affairs and services	2.3	1.8	1.3	1.8	1.4
3. Public order and safety affairs	2.5	2.7	2.0	2.0	2.0
4. Education affairs and services	4.2	6.4	6.0	4.4	5.9
5. Health affairs and services	6.8	4.1	5.6	2.3	6.8
6. Social security and welfare affairs and services	17.2	10.4	16.9	15.7	18.3
7. Housing and community amenity affairs and services	2.5	0.6	1.1	1.1	0.4
8. Recreational, cultural and religious affairs	1.1	2.2	2.2	1.0	0.9
9. Economic affairs	6.4	3.8	5.7	5.1	3.5
10. Environment	.	0.6	0.8	0.7	0.5
Expenditures not classified by major group	3.6				

Source: IMF, Eurostat.

Public debt: General government debt

Croatia's public debt has been on a steady increase in absolute and relative terms over the past couple of years.[10] According to the Ministry of Finance, the general government debt (including government guarantees) rose by HRK 10.2 billion to HRK 110.2 billion or 53% of the estimated GDP by the end of December 2004. This represents an increase of about 1.3 percentage points compared to 2003. However, CNB data suggest a public debt increase of HRK 12.5 billion up to HRK 111.8 billion in December 2004 or 54.1% of the GDP. Both figures do not include pension arrears, an inclusion of which into public debt would increase the debt to GDP indicator significantly. A continuation of this trend may jeopardize Croatia's goal of meeting the Maastricht criteria by 2007. Overall, fiscal

[10] Pursuant to the Croatian Budget Law, government debt is defined as the debt of the consolidated general government budget without guarantees. Government debt plus guarantees is defined as public debt.

developments over the past four to five years have shown two sources of additional debt accumulation: arrears (unpaid internal obligations of the public sector) and contingent liabilities in the form of stare guarantees (World Bank and IFC, 2004).

A look at individual quarters shows that the *general government debt* expanded most in the second quarter of 2004, by close to HRK 5 billion. The highest monthly rise was registered in November, up by HRK 2.4 billion against October, while December saw a substantial contraction. In contrast to previous years when foreign borrowing was the main component of general government debt, in 2004 domestic borrowing contributed most (almost two thirds) to the debt increase and about one third was due to foreign borrowing. In 2003, out of the total debt increase 72% were made up of foreign borrowing, and the remainder by domestic borrowing. However, in the total debt stock the foreign share is still higher (57.8%) than the domestic one (42.2%). The structure of central government debt, which comprises 71% of the total, has experienced a significant change in its foreign and domestic components. While up to 2003 the foreign debt portion was over 60%, it diminished to 54% in 2004, whereas the domestic share increased from 38% in 2003 to 46% in 2004. This turnaround reflects the commitment in the recent agreement with the IMF to 'reduce sharply the reliance on foreign borrowing' (IMF, 2004).

The central government accounted for almost the whole new borrowing in 2004, followed by extra-budgetary funds and the Croatian development bank HBOR, whereas at the same time total guarantees of the Republic of Croatia registered a decline. Government borrowing was done almost exclusively on the domestic market, while extra-budgetary funds' borrowing originated mainly from foreign sources.

Table 7

Public debt in % of GDP, comparison

	1997	1998	1999	2000	2001	2002	2003	2004
Czech Republic	12.7	15.0	16.0	18.2	27.2	30.7	38.3	37.4
Hungary	63.9	61.6	60.9	55.4	52.2	55.5	56.9	57.6
Poland	.	.	40.1	36.8	36.7	41.2	45.4	43.6
Slovakia	33.0	34.0	47.2	49.9	48.7	43.3	42.6	43.6
Slovenia	.	23.6	24.9	27.4	28.1	29.5	29.4	29.4
Estonia	6.3	5.6	6	4.7	4.4	5.3	5.3	4.9
Latria	.	9.8	12.6	12.9	14.9	14.1	14.4	14.4
Lithuania	15.8	16.8	23.0	23.8	22.9	22.4	21.4	19.7
Bulgaria	.	79.6	79.3	73.6	66.2	53.2	46.2	39.1
Romania	16.5	18.0	24.0	23.9	23.2	23.3	21.8	21.8
Croatia	**.**	**.**	**42.3**	**48.9**	**50.3**	**50.4**	**51.7**	**53.2**

Source: AMECO, Ministry of Finance of Croatia.

The changing pattern of borrowing is also reflected when debt is measured as a share of GDP. By the end of 2004 the foreign public debt stock was slightly lower (30.7%) than in December 2003, while the domestic part increased by 1.8 percentage points to 22.5% as a ratio of GDP.

Public debt is also high when compared to the new EU member states. Only Hungary exhibits a higher portion than Croatia, while all others report much lower levels (Table 7). Indeed, most of the new member states have managed to reduce their public debt levels over the past few years or keep them stable. Bulgaria on the other hand had started from a very high level but came down significantly over the last couple of years (see also below).

A closer look at the *central government debt* figures reported by the Croatian National Bank shows that the 2004 debt stock was by HRK 11.9 billion higher than at the end of 2003, representing the most significant increase after 2000.[11] Almost two thirds of the new debt was due to domestic borrowing, one third accounted for foreign borrowing. Within the domestic debt of the government, the debt of the funds was falling over the past two years, while there was a rapid expansion of the republic's debt. A breakdown by financial instrument shows that most of the domestic debt increase accounted for the issuance of bonds, followed by treasury bills, and only a negligible part was due to bank credits. The rise of the external government debt resulted exclusively from a debt increase of government funds through raising credits and issuing bonds, while the republic's debt was even slightly decreasing.

A comparative note on public debt

Comparing the development of public debt across the new EU member states and Croatia, some interesting observations can be made. Those are indirect in the case of Croatia because of the lack of comparable data.

In most NMS, the public debt to GDP ratio is either stagnant or falling, while it is rising in Croatia. Here some of the reasons for these diverging developments will be discussed. This discussion is based on the European Commission's 'General Government Data'. The methodology used to gauge the general government debt dynamics by the EU can be summarized by the following equation:

$$(D_t/Y_t)-(D_{t-1}/Y_t) = (PD_t/Y_{t)})+\{(D_{t-1}/Y_t)*[(i_t-y_t)/(1+y_t)]\}+SF_t$$

where Y is GDP at current prices, D is general government debt, PD is primary deficit, i is the implicit interest rate (actual interest paid divided by stock of debt), y is the nominal GDP

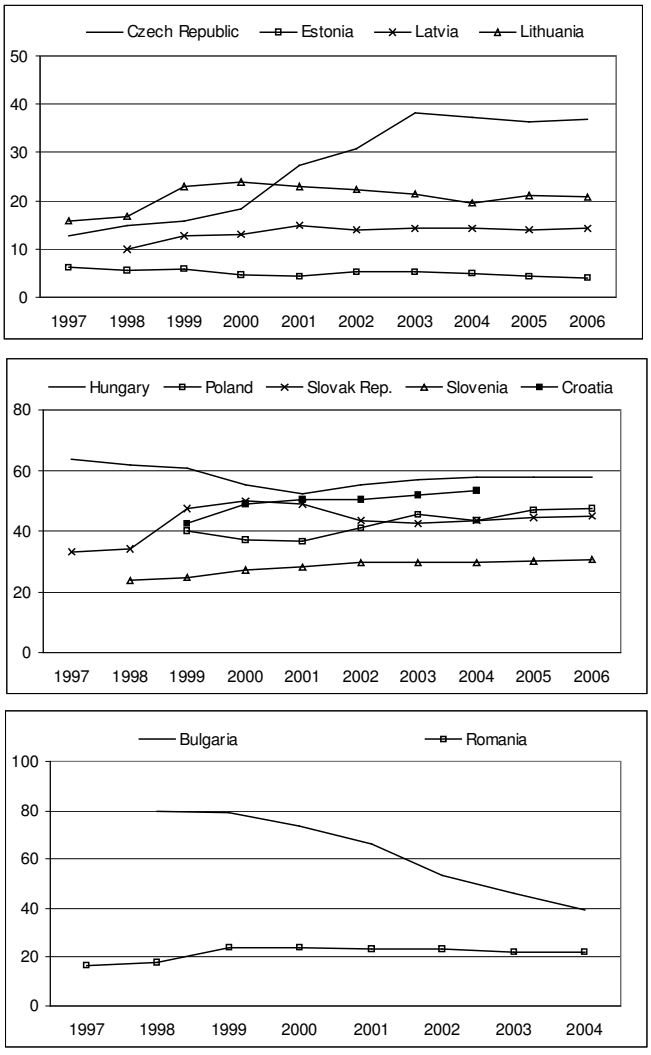
[11] In general, debt figures reported by the National Bank are higher than those of the Ministry of Finance as they include in addition to the Republic's debt also the debt of central government funds. Data published by the Ministry post the increase at almost HRK 10 billion.

growth rate, SF is the stock-flow adjustment and $_t$ stands for time. Therefore, the change in the debt to GDP ratio depends on the primary deficit, PD, on the so-called snowball effect, $(D_{t-1}/Y_t)*[(i_t-y_t)/(1+y_t)]$, and on the stock-flow adjustment, SF. These three factors contribute to the increase or decline of the public debt to GDP ratio.

One important observation is that the implicit interest rate, which is calculated as the ratio of paid interest to the stock of public debt in a particular year, is lower than the nominal growth rate in most NMS most of the time and especially in the last several years. The same development can be observed in the case of Ireland and Spain and in a more ambiguous ways in Portugal and Greece. In these latter cases, this relation between the interest and the growth rates is especially pronounced after the adoption of the euro.

Figure 4

Public debt in % of GDP, comparison



Source: wiiw, AMECO, Ministry of Finance of Croatia.

It is not possible to directly compare the developments in Croatia with those in the NMS due to differences in data and definitions. Still, some indirect comparisons may be indicative. Nominal growth rates are more or less in line with those in the NMS, but it is not known, at this moment in time, what implicit interest rate Croatia is paying. It is rather unlikely that it is above 8%, which is the average nominal growth rate in about the past four years. As the public debt is still rising, that means that the contribution of the other factors must be significant. The valuation effects may be significant, because of the high share of foreign debt in Croatia's public debt. Also, the contribution of the primary deficit has been significant.

The significance of this analysis is that the slowdown of growth together with the stable exchange rate, which both should imply a rather low inflation, may lead to a slowdown of the nominal growth, and the main factor influencing the development of the public debt will have to be the primary deficit. In case that interest rates tend to be more equal to the growth rates, Croatia will have to run significant primary surpluses in order to stabilize its public debt to GDP ratio.

Finally, stock-flow or valuation effects have mainly contributed to the growth of debt. These effects are in some cases significant, especially for foreign debt. It stands to reason that these effects are important in Croatia too, given that, as will be mentioned below, there is a significant difference between the growth of foreign debt and the reported current account deficit. Whether these valuation effects are magnified because of the massive currency substitution in Croatia is an issue that is worth exploring further.[12]

III. Foreign debt

From a comparative perspective we can distinguish at least two groups of countries when analysing external debt developments: those which inherited a huge foreign debt and those with a low initial debt level.[13] Measuring external debt as a proportion of GDP (in euro terms) Croatia belongs to the latter group, with a ratio of about 20% in 1995 (Table 8).

Other comparatively low-indebted countries were the Baltic States but also the Czech Republic and Slovakia, Slovenia and Albania or Ukraine. By contrast, Hungary and Bulgaria were the most indebted countries at the beginning of transition. Up to the year 2004 this picture changed significantly. Bulgaria had managed to reduce its debt burden after the crisis in the late 1990s primarily through strong fiscal adjustments aimed at lowering public external debt. Actually this was achieved, among other things, through debt buybacks and the ongoing real appreciation of the lev, resulting in a fall of the debt ratio.

[12] For some analysis on the factors contributing to the development of the Croatian public debt see Babic et al. (2004).

[13] For further details see Gligorov (2004).

However, the main contribution has come from the fiscal consolidation addressing both the revenue and expenditure side (UNECE, 2003). On the other hand, private sector borrowing has been growing fast over recent years.

Table 8

Gross external debt in % of GDP (EUR)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Czech Republic	33.4	35.0	39.3	38.2	41.1	38.6	37.3	32.8	34.5	35.0
Hungary	71.8	62.0	54.4	56.5	64.9	64.4	64.6	56.0	63.5	64.1
Poland	39.0	31.2	33.0	33.7	42.2	41.4	39.3	40.0	45.3	47.7
Slovak Republic	30.3	37.9	51.7	51.4	54.7	53.1	53.7	49.2	50.6	48.9
Slovenia	29.5	33.4	35.8	34.7	40.0	45.8	47.4	48.8	54.1	59.2
Estonia	.	32.8	53.3	50.5	54.9	54.6	55.6	60.1	70.4	84.4
Latvia	.	37.8	45.6	44.7	56.0	59.9	69.1	70.3	76.6	90.7
Lithuania	.	29.8	33.9	32.4	44.3	42.4	44.3	39.8	41.0	42.8
Albania	32.4	28.4	41.6	24.7	34.2	31.5	28.5	22.0	20.6	.
Bosnia and Herzegovina	.	.	.	.	41.7	40.4	40.3	36.8	32.8	31.3
Bulgaria	78.2	96.8	101.8	81.8	89.3	88.0	79.3	65.1	60.7	63.3
Croatia	**20.4**	**27.0**	**38.0**	**42.8**	**53.2**	**59.4**	**57.8**	**62.2**	**77.6**	**82.1**
Macedonia	.	.	.	.	43.1	41.1	44.5	38.7	35.1	33.8
Romania [1)]	15.6	20.6	24.8	21.7	26.1	27.6	30.1	30.4	31.2	30.7
Serbia	.	.	.	.	.	50.2	105.8	71.2	65.1	57.5
Belarus	.	13.7	15.0	14.1	21.6	18.5	20.6	19.1	17.4	16.6
Russia	38.8	33.3	45.1	67.4	95.9	61.6	49.5	40.3	38.9	33.3
Ukraine [2)]	22.1	20.6	20.4	28.1	45.3	37.7	32.5	27.3	43.5	48.1
Turkey	43.3	43.8	44.5	48.3	56.0	59.6	78.4	71.3	61.2	.

Notes: 1) Medium- and long-term. - 2) Up to 2002 long-term debt only.

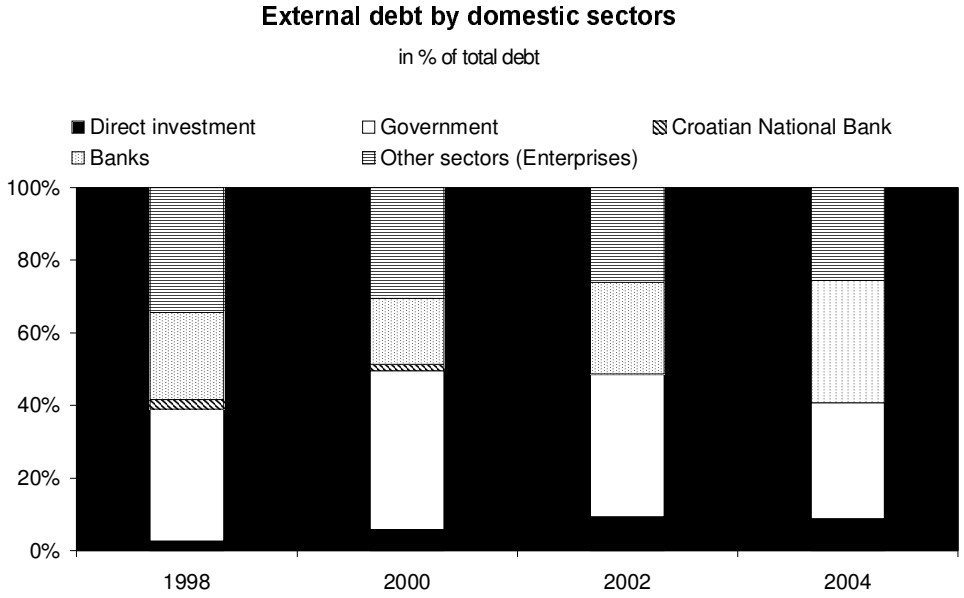
Turkey, another example in the region and somewhere in between the two other groups, started from a relatively low level in 1995, reached a peak in the crisis year 2001 and recovered after a strong devaluation of the Turkish lira. Croatia, Estonia and Latvia are outstanding in that respect, all increasing their foreign debt levels over time. Only in 2001 some improvement was visible in Croatia, while in all other years the jumps were quite substantial. In 2004 the two Baltic countries and Croatia showed the highest debt to GDP ratios.

Structure

An analysis of the Croatian debt stock by domestic debtors points to a high and growing portion of banks while the government's share fell from 40% in 2002 to about 32% in 2004 (Figure 5). At the same time banks took over the leading position for the first time since 1993, accounting for close to 34% of total external debt. Enterprises accounted for high

shares in the period 1998-2002 and settled at about 26% thereafter. Finally, the share of foreign investment rose from some 3% in 1998 to about 8% in 2004.

Figure 5



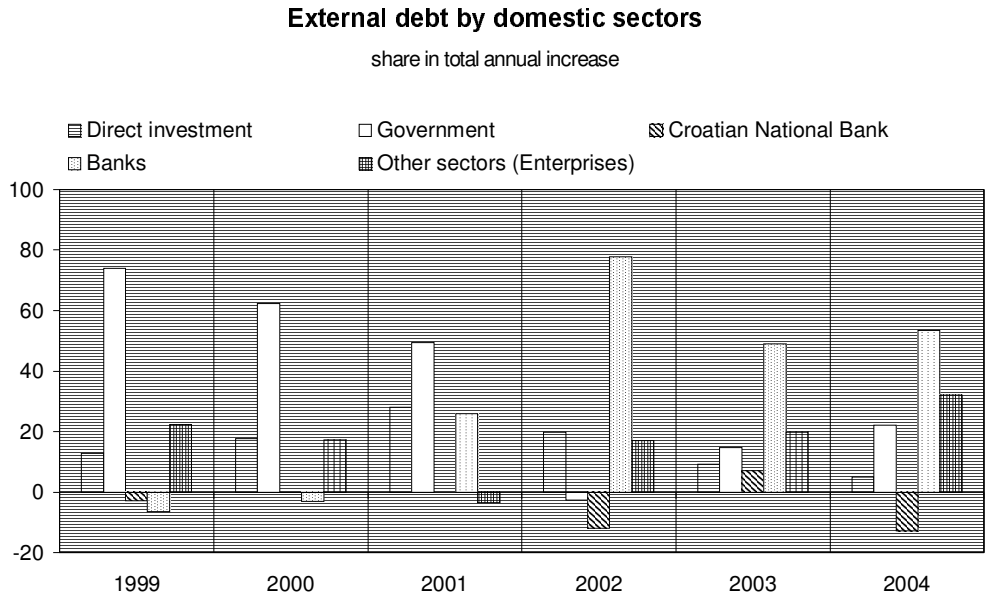
Source: Croatian National Bank.

Overall, the share of the public sector debt decreased by 10 percentage points within the past two years, while at the same time private sector foreign debt grew to over 60% of the total. The maturity structure of foreign debt is satisfactory: by the end of 2004 about 93% of total debt was long-term debt. A breakdown by domestic sectors suggests that public debt is almost exclusively long-term (long-term credits and bonds), while for enterprises and foreign investments the share is about 88% and the banks' share of long-term debt is 91%.

As far as the currency structure is concerned, by the end of 2004 78% of total foreign debt was denominated in euro; dollar debt contributed 11% to the total, while Swiss franks and Japanese yen accounted for 4% each. By domestic sectors, banks' and enterprises' debt has a higher than average euro portion (84%) than that of the state (68%).

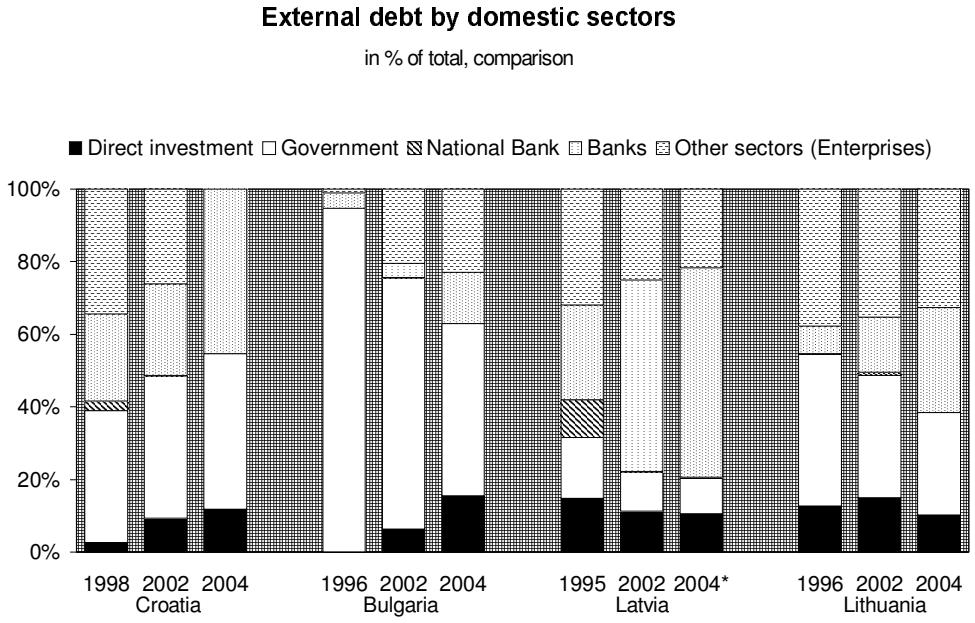
A closer look at the sources of new debt in Croatia shows a steep rise in bank lending; above-average rises were also registered in the enterprise sector in the past couple of years, while on the other hand government borrowing slowed down. Data on the share of individual debtors in the total annual debt increase show that up to 2001 government borrowing accounted for up to two thirds (Figure 6). Thereafter the banks became the prime borrower, but also the enterprise sector had increased again its share in new borrowing – particularly long-term credits.

Figure 6



Source: Croatian National Bank, own calculations.

Figure 7



Note: * 2004: LV 3rd quarter.

Source: National Bank of the respective countries.

Comparing Croatia with the Baltic States or Bulgaria we find that there are some distinctive features related to external debt:

- the expansion of external debt in Croatia in absolute terms is much higher than in any other comparable country;
- the share of government debt in the Baltic States is almost negligible and slowing in Bulgaria – while it is (despite declining) substantial in Croatia;
- finally, the different exchange rate regimes might have influenced public actors' decisions in a different manner, while
- enterprise debt has increased rapidly in all countries.

Debt indicators

Available indicators on Croatia's foreign debt show an unclear picture. Some data suggest that the country is highly indebted, while others point to a moderate debt situation.

Based on the World Bank debt indicators,

- the debt to GDP ratio at over 80% points to a highly indebted country;
- in terms of debt to exports of goods and services (170%), Croatia's debt burden is moderate;
- the debt service to GDP ratio (20%) again points to a moderately indebted country, and
- the ratio of interest payments to exports of goods and services (4.2%) suggests even a low debt burden; however,
- debt to tax revenues is at a rather high level: it is over 250%, a cut-off point for severe indebtedness, if social contributions are excluded, and it is around 200% if they are included, which is still a rather high figure (see Table 9).

Table 9

Croatia: external debt in % of tax revenues

	1999	2000	2001	2002	2003	2004
External debt, EUR million	9937.2	11865.2	12827.6	15054.8	19810.6	22675.4
External debt to tax revenues, %	175.4	202.4	210.6	220.3	278.4	301.3
External debt to tax and soc. sec. contr. reven., %	119.6	139.3	143.0	153.6	192.9	197.8

Source: Ministry of Finance, Annual Report, 2004: Monthly Statistical Review.

Figure 8a

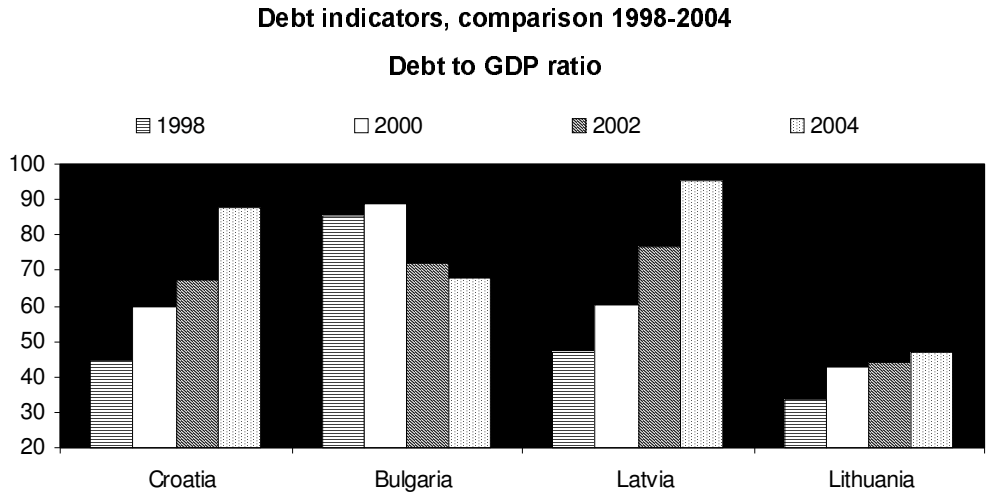
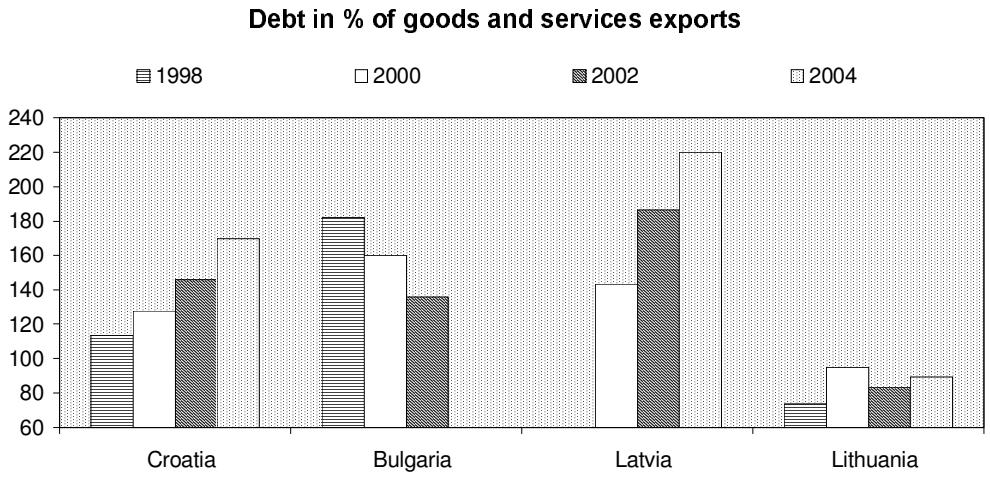
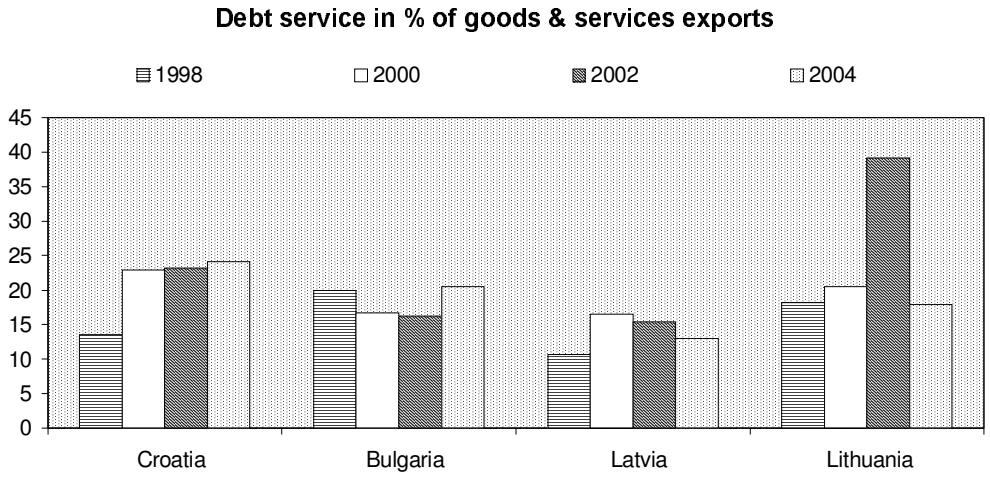


Figure 8b



Source: Transition Report 2004, CNB, BNB.

Figure 8c



Source: Transition Report 2004.

The most recent report of the World Bank on Global Development Finance 2005 has downgraded Croatia to a 'severely indebted middle income country' from a 'moderately indebted middle income country' in the past couple of years.[14]

Croatia's foreign debt has continued to grow in 2004. Though growth has slowed down as compared to the previous, 2003, year, it is around the average growth rate for about the past ten years. In 2004 the debt to GDP ratio was by about 8 percentage points higher than in 2003, which is about the average. Debt to exports of goods and services has in fact grown faster than on average, leading to a rather high ratio in dollar terms, around 170%. All other indicators are recording growth, though the speed is much more difficult to evaluate.

The trend growth of debt to GDP and to exports of goods and services, which are the two main indicators of indebtedness, has been considered unsustainable in the sense that it implies problems with the solvency of the Croatian economy. Given that there has been no clear break in the trend rate of growth of foreign debt, its development has to be assessed as being unsustainable still.

That does not mean that its growth is necessarily explosive in the sense that the debt to GDP ratio will grow for ever. In fact, if reported developments in the current account are taken, Croatia's debt to GDP ratio should stabilize at a sustainable level. Table 10 compares Croatia with the other Southeast European countries and shows that it does not belong to the group of those that have current account deficits that are way too high for their growth rates.

Table 10

Sustainable foreign debt

	average annual euro nominal growth rate in % 2004/2000	Current account In % of GDP 2000-2004	Curr. account/GDP nom. growth rate GDP
Albania	13.1	-5.8	45 %
Bosnia and Herzegovina	6.6	-26.2	394 %
Bulgaria	9.3	-6.9	74 %
Croatia	8.5	-5.8	68 %
Macedonia	2.2	-5.8	260 %
Romania	9.1	-5.2	57 %
Serbia and Montenegro	9.2	-10.7	116 %

[14] The World Bank criterion is that a country is severely indebted if either its debt to GDP ratio is above 80% or its debt to exports of goods and services is above 220% – either one is sufficient.

However, there is a problem in the case of Croatia. It reports current account deficits that are way below its net new foreign debt. Thus, in 2004, new foreign debt was close to EUR 3 billion, while the current account deficit was below EUR 1.3 billion. There is a difference of close to EUR 2 billion. As reserves did not grow in that year, the difference has to be attributed either to the underestimation of the current account deficit or to capital flight or to valuation effects. In any case, if the rate of growth rather than the current account deficit is taken to assess the implied level of debt to GDP at which that rate will stabilize, it is well above 150%. It is hard to believe that this is the level that foreign investors will feel at ease with.

Thus, there is no doubt that Croatia still faces the task of putting its external balances on the path of sustainability.

IV. Policy issues and alternatives

Introduction

Croatia's economic policy has been facing two persistent problems: a high fiscal deficit and growing foreign debt. Both have been aggravated in the late 1990s when macroeconomic stability was threatened in the crisis that led to the collapse of the banking sector and the recession and was additionally sacrificed through increased public spending in the wake of the crucial elections in early 2000. Since then, the fiscal deficit has proved to be difficult to rein in, because that requires reforms in the structure of rights, while the foreign debt has continued to grow fast due to persistent trade and current account deficits. In 2003, both current account and fiscal deficits recorded quite high values, while foreign debt increased by a record amount.

The policy to deal with these macroeconomic imbalances adopted by the government and the central bank on the advice from the IMF in the past couple of years is that of soft-landing, which is certainly the appropriate one. The essence of it is the attempt to improve macroeconomic balances with a slowdown of growth. In 2004, that seems to have been achieved, though perhaps not to the extent that was originally intended. Early in 2005, there are worries that it is in fact overshooting with growth slowing down faster than expected or desired.

This policy has brought mixed results so far and it is not clear whether the continued reliance on it will be sufficient to move the economy to a path of sustainable growth rather than proving to be a short-term deviation from the unsustainable growth path. In any case, the policy adjustment measures that have been introduced will have to be supplemented with longer-term changes and eventually with structural reforms. In the brief discussion that

follows, policy challenges will be highlighted, alternative policy mixes will be discussed and some basic policy issues will be commented on.

Current economic policy strategy

Since the stabilization in 1994, Croatia has had problems with its external balances and since 1999 with its fiscal balances too. The latter have been the consequence of the unreformed public sector and the strong presence of the political business cycle. The external imbalance has also been large mainly as a consequence of the large trade deficit. The surplus on the balance of services has not fully compensated for the trade deficit. Lately, a deficit on the income balance has also developed. Thus, there is a persistent current account deficit. In addition, there is a large errors and omissions position in the balance of payments that is hard to account for.

The consequence of the persistent external imbalance is growing foreign debt, which has been identified, somewhat belatedly, as the main threat to macroeconomic stability. That has led to the adoption of a number of measures that should engineer a soft-landing. In sum, these measures should slow down the growth of aggregate demand and thus lead to slower growth of imports and should stabilize the foreign debt to GDP ratio somewhere around 80% (in euro terms).

In addition, public expenditures should stop increasing and the fiscal deficit should start decreasing. The aim is to bring it gradually down to below 3% of GDP by the year 2007. Also, the government is determined to borrow in domestic rather than foreign currencies in order to diminish the risks associated with the exchange rate and interest rate movements. This should also increase the role of the domestic currency and diminish the rather high level of currency substitution. If indeed the domestic money market is developed, then the monetary policy will have more room to manoeuvre.

These demand-side measures are supposed to be helped by positive supply-side developments. Those are premised on the structural reforms that should include the speed-up of privatization, the reform of the labour market and, last but not least, a far-reaching reform of the public sector. Some of these reforms will be necessary anyway as they are part of the Croatian convergence and harmonization with the European Union. In the end, Croatia should be ready to join the EU and adopt the euro with a reformed public sector and competitive market economy and with the fulfilment of the Maastricht criteria.

Policy challenges

The strategy of soft-landing faces a number of challenges. If those prove to be insurmountable, alternative strategies should be considered. Here a number of problems will be discussed and then some alternative policies will be considered.

What about relative prices? If imports are to slow down, consumption has to slow down, and that means that growth should slow down too. This may not affect relative prices and especially the exchange rate. This is consistent with the view that a change in relative prices should come through a supply-side adjustment. The enterprise sector should cut costs, i.e., it should save on employment. Whether the labour market reforms will lead to more competition and thus to a lowering of the wages and then to increased hiring is hard to tell. The answer will partly depend on the restructuring of the public sector because the most stubborn wages are to be found there. Clearly, all that will take time and it is questionable whether that implies a low growth rate over that whole period of time. If it does, that of course is an additional risk.

This is clearly the key issue. If public spending and private consumption are to be reduced, growth should be pushed by private investments and net exports. Some of these changes in the structure of aggregate demand are already taking place, as discussed at the beginning of this paper, but those may require appropriate changes in relative prices, because restrictive monetary and fiscal policies may not be enough.

What about public investments? Saving on public expenditures means primarily saving on investments because the other parts of public expenditures require reallocation of rights, which is of course a political issue. Croatia has indeed had an ambitious programme of public investments that will have to be scaled down – at least as long as a reform in the entitlements takes place. That may take some time. Pension reforms as well as reforms of the health and education sectors are usually not very popular and take some time to be put in place. There is no doubt that those are necessary, the issue is how feasible they are and whether public investments can and should be postponed for a prolonged period of time.

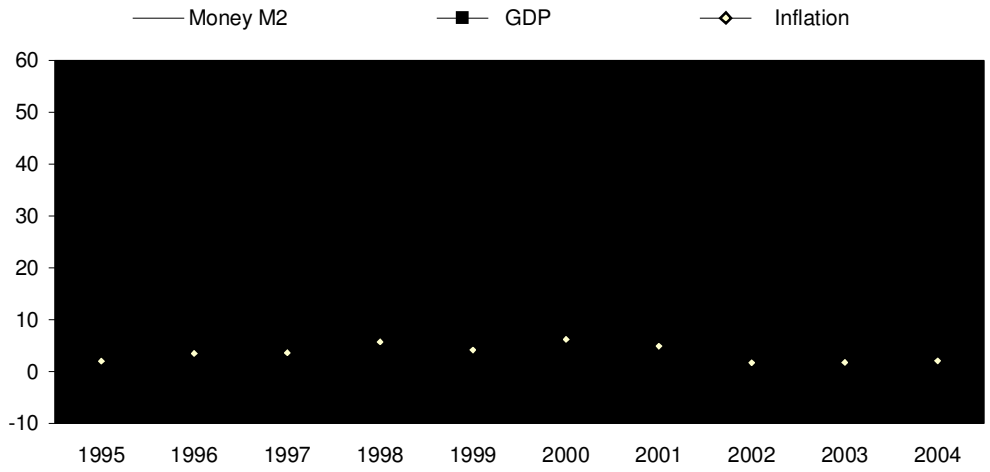
Is the policy mix appropriate? Currently, both monetary and fiscal policy should continue to be somewhat restrictive. Putting aside the question of feasibility, there is the issue of whether this is the appropriate policy mix. If interest rates are going to go up and the government is to borrow increasingly on domestic markets, that may lead to an acceleration of the growth of public debt. It may also lead to an appreciation of kuna, as has in fact been the case in 2005. That may require further savings in public expenditures. Again, this policy mix could work if public sector reforms are going to be implemented speedily and efficiently.

It is also not clear what is the influence of monetary policy. On the descriptive level, it does not seem to be very effective as can be seen from the Figure 9. Large swings in money growth have not resulted in comparable corrections in inflation and growth. The effectiveness of the fiscal policy may be higher, but that essentially means reliance on the changes in discretionary spending, i.e., in public investments.

Figure 9

Money M2, GDP and inflation, 1995-2004

real change in % against preceding year



Source: wiiw incorporating national statistics.

The timing of structural reforms: The speed-up of privatization would be useful, but it is not clear whether this is indeed possible. It would be even better to attract greenfield foreign investments, but it is not clear whether much can be done to attract them. Labour market reforms may prove to be useful, but increased flexibility may increase competition for the exiting jobs while the creation of new jobs will depend more on the influence of the increased flexibility of wages. If wages prove to be sticky downwards, then increased flexibility will not lead to much more investment and higher growth. Other structural reforms, for instance the use of competition policy, will take time even if they are pursued aggressively, which is not assured.

In general, it seems that the current economic policy is geared towards a short-term adjustment of public expenditures and some slowdown in imports, but the supply-side response is not targeted with the changes in relative prices but more through structural reforms that may take a while to be devised and implemented.

Policy alternatives

Croatia's macroeconomic stability is presumed on the stability of its exchange rate. That is not, in itself, wrong. A small, open economy with low credibility, both when it comes to its monetary and its fiscal policy, probably needs the exchange rate anchor. A problem arises when the exchange rate looks like being misaligned, which is indicated by the unsustainable growth of foreign debt. In that case, clinging to wrong relative prices may prove to be a very serious problem. If that is so, then an adjustment in the exchange rate may be appropriate. The issue really is not adjustment or no adjustment, but what policy of adjustment.

If foreign debt growth is unsustainable, that is the same as saying that there will be an involuntary exchange rate adjustment some time in the future. It may not be easy, of course, to determine whether the growth of foreign debt is not sustainable. But, if it is, then the exchange rate will have to give at one point in the future. In that case it is preferable that the adjustment to the new exchange rate level that is consistent with a sustainable growth of foreign debt takes place gradually and over a period of time. The end result is the same, but the costs are higher if there is an abrupt adjustment in the exchange rate.

That is then one policy alternative: to affect the change in relative prices via a depreciation of the real exchange rate. This is not a substitute either to fiscal adjustment or to the need for structural reforms. In fact, it should be seen as a complement to both. Its positive contribution should come through a slowdown of imports and a boost to exports. The effects on the various balance sheets should be taken into consideration. Those may not be an insurmountable obstacle, but have to be looked into carefully.

If the exchange rate adjustment is not possible because of large balance sheet effects, the alternative is a more aggressive wage policy. That is usually rather difficult to implement. The obstacles coming from political economy are clear and have been recognized by most economists, starting with Milton Friedman. There have been examples of such adjustments and thus that alternative cannot be altogether excluded. If, however, the government is not strong enough to introduce effective wage policies, then it will in all probability not be strong enough to introduce most other structural reforms either. That is the main risk of this policy alternative.

There is a possibility to have more active supply-side policies. Those would involve significant changes in the tax system. In a number of countries in transition the corporate tax has been decreased quite significantly. It turns out that a policy of low taxation does not cost the budget too much, because the revenues from the corporate income tax are small anyway, but do create an incentive for foreign investors to locate their operations in these tax havens. This is not a measure that by itself would turn the economy around, but could be considered as a supplement for the economic policy and structural reforms that are

difficult to implement immediately. The idea would be to increase investments and growth and introduce structural and public sector reforms in a fast growing economy.

V. Conclusion

It is not certain that the current programme of adjustment will lead the Croatian economy to a path of sustainable growth. Indeed, to the extent that it will rely on a slowdown of growth it may be just a short-term solution and the problems will reappear soon enough. Thus, measures should be considered to increase the competitiveness of the Croatian economy and keep the high level of investment. Clearly, structural reforms are necessary, but policies that aim to support a more efficient structure of relative prices, especially those that are determined through the exchange rate or wages or both, should be considered too.

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APPENDIX

Table A/1

Croatia: Consolidated general government revenues and expenditures by different sources

in % of GDP

	1997	1998	1999	2000	2001	2002	2003	2004
MinFin Annual Report 2002/03								
Revenues and grants	.	.	53.0	48.9	47.6	46.2	46.6	.
Expenditures & net lending	.	.	55.2	54.0	50.8	48.8	49.5	.
MinFin (Statistical Review) own calc.								
Revenues and grants	.	.	.	.	.	46.3	46.4	46.5
Expenditures & net lending	.	.	.	.	.	48.3	49.7	49.5
IMF (August 2004, p. 45), GFS 1986								
Revenues and grants	.	51.1	48.4	46.2	44.0	44.5	44.3	.
Expenditures & net lending	.	54.6	56.6	52.7	50.7	49.6	50.6	.
IMF Information Note (August 2004)								
Revenues and grants	.	.	.	.	44.0	46.3	46.4	.
Expenditures & net lending	.	.	.	.	50.7	51.4	52.7	.
Pre-accession programme, ESA								
Revenues and grants	.	.	.	.	.	.	46.4	47.7
Expenditures & net lending	.	.	.	.	.	.	50.8	51.1
World Bank 2003, Rep. 25434-HR, p. 11								
Revenues and grants	.	.	.	.	.	.	.	.
Expenditures & net lending	51.3	53.8	57.0	53.2	53.5	51.7	.	.
Croatian Economic Survey 7/2004								
Svaljek et al., pp. 76ff.								
Revenues and grants	47.6	50.8	48.1	46.5	45.2	44.8	44.7	.
Expenditures & net lending	49.8	52.4	54.9	53.7	50.6	49.9	49.7	.