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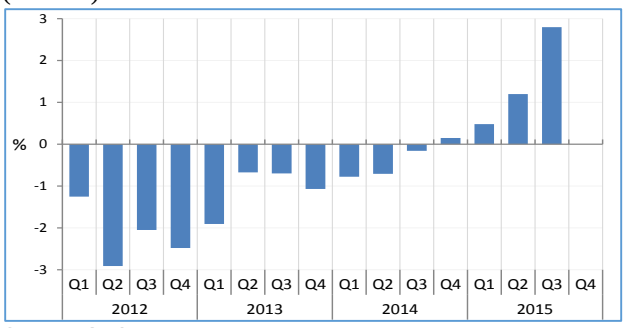
MACRO MONITORING REPORT
December 2015

CROATIA

After six years of economic contraction, Croatia started a gradual recovery in 2015. Continued recovery in the EU and events in competing tourism markets boosted Croatia's exports of goods and services, while oil and food price declines and income tax changes contributed to a rebound in private consumption. Although the trade balance improved, pushing the current account surplus to a record high, external debt reached 109 percent of GDP by August 2015, indicating still high external vulnerability. The general government deficit is expected to be around 5 percent of GDP in 2015, increasing public debt to close to 90 percent of GDP. The Excessive Deficit Procedure (EDP) target budget deficit of 4.6 percent of GDP is out of reach. Despite the modest recovery in 2015, the economy requires urgent reforms to consolidate its finances, increase competitiveness and boost employment. After parliamentary elections in early November, Croatia faces difficult negotiations to form a government.

Growth strengthened in Q3 and was relatively broad based. After real annual growth of 0.8 percent in the first half of the year, growth accelerated to 2.8 percent in the third quarter of 2015. This was the fourth consecutive quarter of positive GDP growth and the highest since the second quarter of 2008. Growth was broad based, with income tax changes and growing consumer confidence supporting real growth of 1.4 percent in private consumption, while investments picked up for the second quarter in a row, by 2.2 percent. High frequency data point to continued positive growth in the last quarter. Driven by increased external demand, industrial production surged in October, by 6.4 percent y-o-y, especially in food, chemical, wood and pharmaceutical industries. Higher household disposable income boosted retail trade growth to 1.5 percent in October, while tourist arrivals and night stays benefitted from the extended tourist season.

Real GDP, annual growth rates
(Percent)



Source: CBS.

The labor market improved slightly as growth prospects recovered and employment support measures strengthened. The survey-based unemployment rate declined to 16.9 percent in the first half of 2015 (a four-quarter average), 0.5 percentage points down to the same period last year. Further, activity and employment rates increased (to 52.8 percent and 43.9 percent, respectively), although remaining well below the EU average. The administrative unemployment data continued its year and a half long downward trend supported by public sector and service sector employment, as well as active labor market programs for vulnerable groups and youth that prevented further deterioration. Croatia has doubled the amount of employment subsidies supported by the EU Youth Guarantee Scheme in 2015.

The current account balance recorded a surplus for the first-time in the second quarter of 2015. This was mainly due to improvements in the trade balance, as exports grew by 14.2 percent y-o-y on the back of ships, motor vehicles, fabricated metal and food products. A solid tourist preseason (revenues up by 6.4 percent y-o-y) increased the services surplus, while an additional contribution to the current account surplus came from the rise in compensation of employees and doubled transfers from the EU. Cumulatively, in the last four quarters, the current account surplus reached a record high of 2.1 percent of GDP. Goods exports continued to increase in the third quarter, which combined with decelerating import growth led to a narrowing of the trade deficit to 15.2 percent of GDP in September, 0.7 percentage points below the same period last year.

Foreign direct investment (FDI) decreased in the first half of 2015. This was mainly due to profit transfers abroad, especially in telecommunications, and losses in foreign-owned banking sector affected by the mandatory conversion of the CHF-denominated loans. About 18 percent of total FDI in the first half of the year went to chemical industries and nearly 15 percent to construction.

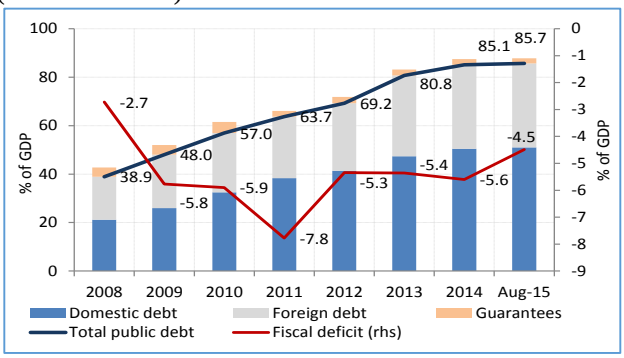
External debt is still on rise led by public sector debt. Still in relative terms, by August 2015, it reached 108.9 percent of GDP in gross terms, only 0.5 percentage points of GDP above the end-2014. A rise of external debt is to be attributed to public sector (i.e. March bond issue of EUR1.5 bn) as well as the central bank repo-auction related debt growth. The net international investment position remained largely unchanged, at 89 percent of GDP, compared to end-2014.

The budget deficit and fiscal vulnerabilities remain high. The general government deficit reached 4.5 percent of GDP by June 2015 (at ESA2010), having recorded 5.6 percent of GDP in 2014. Revenue growth was supported by an increase in social contributions and stronger VAT collection (8.1 percent y-o-y), thanks to the recovery of private consumption and pre-season tourism. At the same time expenditures

stagnated as increases in intermediate consumption and interest payments were offset by a decline in social security benefits. Transfers from the EU budget doubled, contributing to improved revenues. However, general government debt continued rising, reaching 85.7 percent of GDP by August 2015, up from 85.1 percent of GDP in 2014 and is expected to reach 89.8 percent of GDP in 2015 and stabilize only in 2018.

In its 2015 Convergence Program, the Government planned to correct the excessive deficit by 2017. The Fiscal deficit is projected at 5 percent of GDP in 2015, 3.9 percent in 2016, 2.7 percent in 2017 and 2.4 percent in 2018 (at ESA2010). However, this is not in line with the recommendation by the European Council to have the deficit below 3 percent of GDP by 2016. Nonetheless, in June 2015 decided not to activate corrective action against Croatia, but pointed out that the "level of ambition remains below expectations in a number of areas". Croatia was also given six new recommendations for reforms in 2015 and 2016.

General government deficit and debt
(Percent of GDP)



Note: Fiscal deficit in 2015 refers to H1.
Source: MoF, CBS, WB staff calculations.

Deleveraging continued in 2015 on the back of corporate sector domestic deleveraging. Lending activity declined by 2.7 percent y-o-y in October led by accelerated corporate deleveraging (4.5 percent), which turned to direct foreign borrowing. Deposits increased by 3.4 percent, while NPLs remained unchanged in September 2015, compared to end-2014, at 17.1 percent, with corporates and households at 31.1 percent and 12.1 percent, respectively.

In September, Parliament enacted the law to convert all CHF-loans to EUR-loans. The Constitutional Court rejected the banks' call to suspend regulations on CHF-loan conversion. Both disputed laws regulating the conversion of CHF-loans (on credit institutions and consumer credit) will remain in force until a final ruling on their constitutionality is made. The banks were given a deadline until November 15 to send their clients amended loan contracts, after which time loans holders have one month to decide on the conversion—this refers to about 4 percent of households and will result in bank losses and fiscal revenues foregone of around 2.1 and 0.3 percent of GDP, respectively.

The central bank continued to ensure liquidity and stabilize interest rates. Following the enactment of the CHF-denominated loans conversion act, the central bank intervened in September for the third time this year in the FX market by selling EUR268.3 million to withdraw HRK2.05 bn (after withdrawing HRK3.8 bn in January and February). This prevented a kuna depreciation, stabilized interest rates, and provided liquidity for banks. Additionally, to ensure kuna liquidity, the central bank revoked compulsory purchases of CB bills and recommenced (after October 2009) reverse repurchase (repo) auctions every week from end-September.

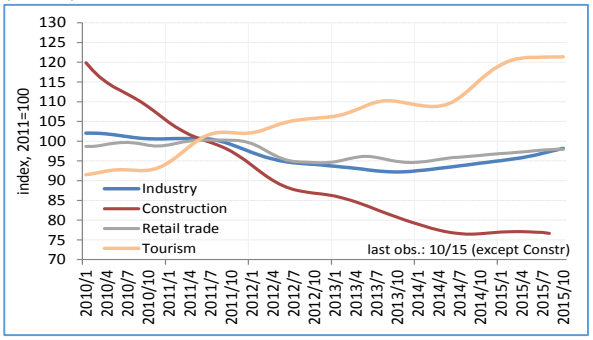
Despite increased liquidity, deflationary pressures intensified in the second half of 2015. Led by declining oil and gas prices, the annual CPI declined by 0.8 percent in October and 0.4 percent in the first ten months of 2015 (having declined 0.2 percent in 2014).

After parliamentary elections on November 8 Croatia faces difficult negotiations to form a government. With turnout of about 61 percent, the Croatian Democratic Union (HDZ)-led Patriotic Coalition won more votes (59 MPs) in the 151-seat parliament, but not enough to form a government on its own. The Social Democratic Party (SDP)-led *Croatia is Growing Coalition* got 56 seats, while amongst the biggest surprises was the party 'Most' (the Bridge), winning 19 seats in the Parliament thus playing a crucial role in the government formation. After the inaugural session of Parliament's assembly ended without electing a speaker, discussions between HDZ, SDP and Most will continue.

In November, through the Alert Mechanism Report, the EC requested another in-depth review (IDR) for Croatia, as part of the Macroeconomic Imbalance Procedure (MIP). In the updated MIP scoreboard, a number of indicators are beyond their indicative thresholds, namely the negative net international investment position (NIIP), there have been substantial losses in export market shares, steadily increasing government debt, high unemployment (as well as the increase in long-term and youth unemployment). The EC will present the conclusions of the IDRs in February 2016.

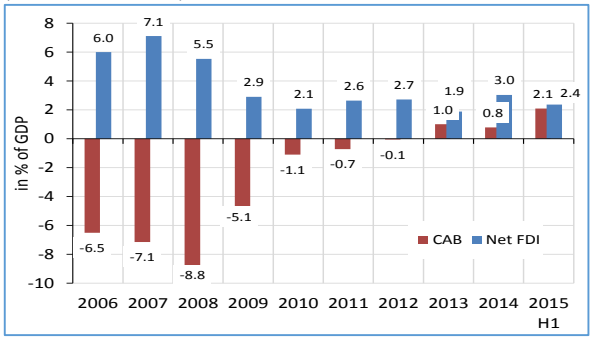
Economic activity is expected to increase by 1.5 percent in 2015, with risks skewed to the downside. The recovery is expected to continue in 2016-17 at on average 1.6 percent, led by strengthening domestic demand, exports and investment while unemployment continues to gradually decline. However, external factors, like a slowdown in Croatia's main trading partners, the Fed's tightening monetary policy and a surge in emerging market risk premium, could undermine Croatia's fragile recovery, affecting exports and raising financing costs of an already highly indebted government and other domestic sectors. On the domestic side, difficulties in forming a new government, and uncertain scope of fiscal consolidation measures for 2016 and 2017 could hamper the growth outlook. To ensure macroeconomic stability and growth, addressing fiscal vulnerabilities as well as high inactivity and unemployment rates, and a commitment to implement long-lasting structural reforms remains crucial.

High frequency data, trend-cycle adjusted series
(Index)



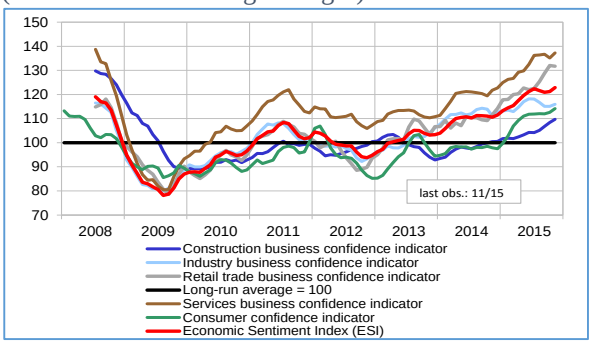
Source: CBS, WB staff calculations.

Current account balance and net foreign direct investments
(Percent of GDP)



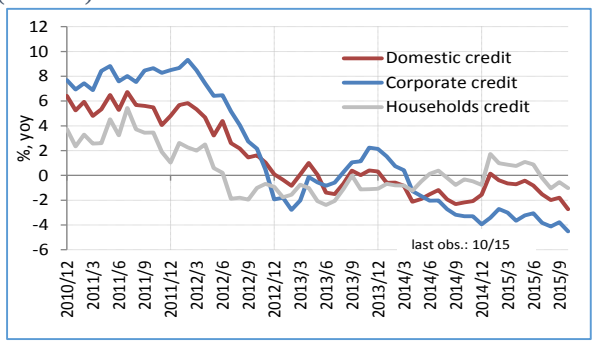
Source: CNB, CBS, WB staff calculations.

Business and consumer confidence
(Three-member moving averages)



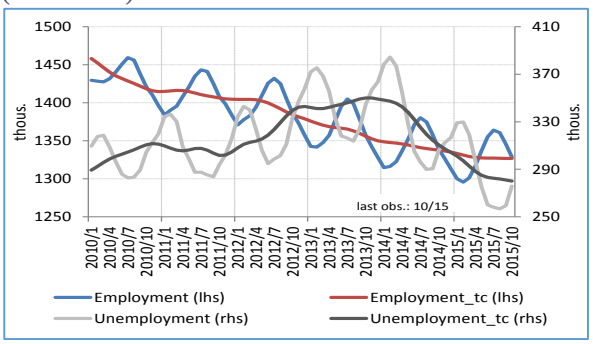
Source: EC, WB staff calculations.

Loans, annual growth
(Percent)



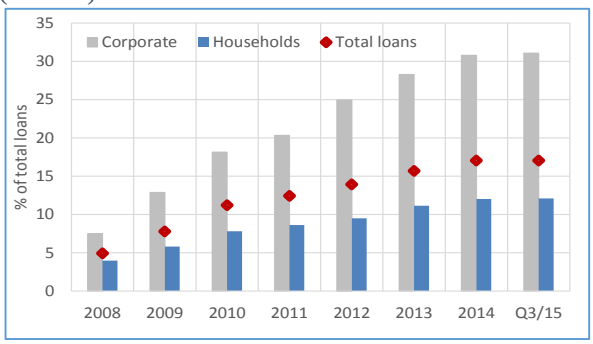
Source: CNB, WB staff calculations.

Labor market, administrative data
(Thousands)



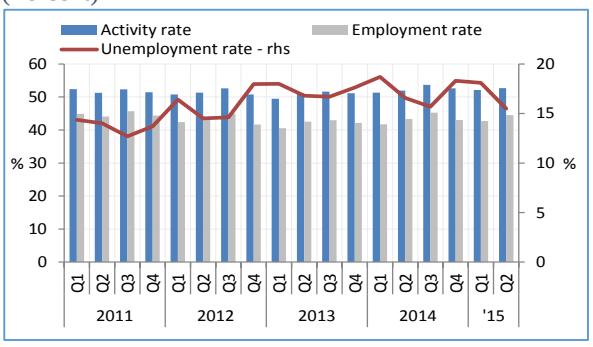
Source: CBS, WB staff calculations.

Non-performing loans
(Percent)



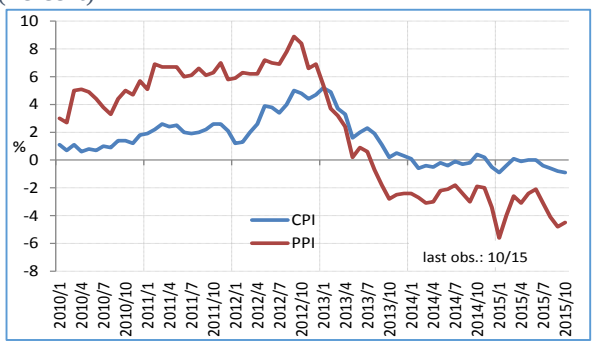
Source: CNB.

Labor market, survey-based data
(Percent)



Source: CBS.

CPI and PPI, annual growth rates
(Percent)



Source: CBS.

Croatia

Selected Indicators	Avg. '00-14	2011	2012	2013	2014	2015 E	2016 F
Income and economic growth							
GDP growth (annual %)	1.7	-0.3	-2.2	-1.1	-0.4	1.5	1.7
GDP per capita growth (annual %, real)	2.2	2.9	-1.9	-0.8	0.0	1.7	2.0
GDP per capita (US$, nominal)	11128.4	14542.3	13236.1	13574.9	13475.4	12715.5	13043.6
GDP per capita, PPP (current international $)	17231.8	20571.2	21113.6	21350.5	21252.3	21710.2	22177.9
Private Consumption growth (annual %)	1.6	0.3	-3.0	-1.8	-0.7	0.8	1.0
Gross Investment (% of nominal GDP)	23.1	20.3	19.6	19.8	19.1	19.1	19.4
Gross Investment - Public (% of nominal GDP)[1]	4.9	3.5	3.5	3.7	3.7	3.6	3.5
Money and Prices							
Inflation, consumer prices (annual %, end of period)[2]	2.6	2.1	4.7	0.3	-0.5	0.9	1.7
Inflation, consumer prices (annual %, period average)[2]	2.7	2.2	3.4	2.2	-0.2	-0.2	1.0
M2 (% of GDP)	67.8	76.4	79.3	82.2	85.0	86.0	87.0
Domestic Credit to the Private Sector (% of GDP)[1]	59.8	75.8	71.5	71.0	69.9	69.0	68.8
10 year interest rate (annual average)[2]	..	..	..	..	..	..	..
Nominal Exchange Rate (local currency per USD)	6.2	5.3	5.9	5.7	5.8	6.2	6.2
Real Exchange Rate Index (2010=100)	101.4	97.9	96.6	97.3	96.2	101.8	103.2
Fiscal							
Revenue (% of GDP)	42.1	41.0	41.7	42.5	42.6	42.2	42.3
Expenditure (% of GDP)	46.5	48.8	47.1	47.8	48.2	47.1	46.3
Interest Payments (% of GDP)	2.3	3.0	3.4	3.5	3.5	3.6	3.6
Non-Interest Expenditure (% of GDP)	44.3	45.7	43.7	44.3	44.7	43.5	42.7
Overall Fiscal Balance (% of GDP)	-4.4	-7.8	-5.3	-5.4	-5.6	-4.9	-3.9
Primary Fiscal Balance (% of GDP)	-2.1	-4.7	-2.0	-1.9	-2.1	-1.3	-0.3
General Government Debt (% of GDP)	49.6	63.7	69.2	80.8	85.1	89.8	92.0
External Public Debt (% of GDP)[1]	23.4	25.4	27.9	33.3	34.7	37.4	41.1
External Accounts							
Export growth, f.o.b (nominal US$, annual %)	10.0	13.5	-7.8	6.4	7.0	-1.3	3.1
Import growth, c.i.f (nominal US$, annual %)	8.4	12.1	-8.8	5.9	3.4	-2.3	4.7
Merchandise exports (% of GDP)	17.1	19.6	19.7	20.5	22.7	23.8	24.0
Merchandise imports (% of GDP)	35.5	33.9	34.0	35.6	37.5	38.9	39.8
Services, net (% of GDP)	14.3	14.1	14.6	15.5	16.9	17.7	17.7
Current account balance (current US$ millions)	-1754.9	-316.6	-168.8	559.5	415.2	2057.3	524.1
Current account balance (% of GDP)	-3.7	-0.5	-0.3	1.0	0.7	3.8	1.0
Foreign Direct Investment, net inflows (% of GDP)	3.6	2.7	2.7	1.9	3.0	3.2	3.4
External debt, total (% of GDP)[1]	81.5	103.7	103.0	105.6	108.4	107.5	109.2
Multilateral debt (% of total external debt)[1]	6.3	7.3	8.3	9.0	9.8	11.0	11.7
Debt service ratio (% of exports goods and non-factor services)[1]	42.3	66.1	63.6	51.4	52.9	51.7	44.1
Population, Employment and Poverty							
Population, total (millions)	4.4	4.3	4.3	4.3	4.2	4.2	4.2
Population Growth (annual %)	-0.5	-3.1	-0.3	-0.3	-0.4	-0.2	-0.3
Unemployment Rate[1]	13.5	13.7	15.9	17.3	17.3	16.9	16.5
Poverty headcount ratio at national poverty line (% of population)[1]	20.2	20.9	20.4	19.5	19.4	..	..
Poverty headcount ratio at US$5 a day (PPP) (% of population)[1]	8.4	8.4	9.4	9.7	9.8	9.3	9.0
Inequality - Gini Coefficient[1]	31.1	31.2	30.9	30.9	30.2	..	..
Life Expectancy[1]	75.6	76.8	76.9	77.1	..	..	..
Other							
GDP (current LCU, millions)	285601.4	332587.0	330456.0	329571.3	328430.5	335166.6	342937.2
GDP (current US$, millions)	48711.8	62249.9	56485.6	57770.4	57113.9	53798.8	55046.1
GDP per capita LCU (real)	71692.4	76418.3	74975.5	74384.7	74419.1	75668.0	77151.4
Doing Business Rank[3]	39	..	..	..	39	40	..
Human Development Index Ranking[4]	46	45.0	47.0	47.0	..	..	..

Notes: ".." indicates not available. E = estimate, F = forecast. Data from MFMOD unless otherwise noted.

1/ World Development Indicators Database

2/ World Bank GEM database

3/ This indicator is ranked out of 175 countries in 2007, 178 in 2008, 181 in 2009, and 183 in 2010 and 2011.

4/ The HDI ranking in 2001 is in relation to 175 countries and in 2010 in relation to 169 countries. Methodological enhancements in HDI calculations have resulted in notable improvements in the countries' rankings.

Sources: MFMOD Database, World Bank WDI, GEM databases, IMF and national sources.