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## **Croatia: a new EU candidate**

Economic indicators for the first months of 2004 point to a slowdown in growth. Industrial production growth has gradually lost momentum over recent months. In the first five months of the year, it rose 4.1% (down from 5.6% in the first quarter). Within industry, manufacturing showed above-average growth, the highest growth rates being registered in basic metals, publishing and printing, wood and wood products, electrical machinery and equipment and other transport equipment. Continued downsizing of the workforce in industry led to a further increase in productivity. Construction activities remained strong. Retail trade turnover increased by 2% in real terms. As of January this year, Croatia adopted a new methodology for measuring inflation, replacing the retail price index by the consumer price index. Consumer prices rose by 2.4% in May year-on-year.

The increase in total employment (based on registration data) that had started in 2003 continued at an accelerated rate of growth throughout the first quarter of 2004. Registered unemployment fell to 18.6% in April. Data derived from the labour force survey indicate an unemployment rate of 14% in the second half of 2003 (latest available data). Despite an improvement on both counts, unemployment remains high compared to most of the new EU member states. Average real net wages have continued to grow, increasing by 4.2% in the first quarter of the year as against 3.8% in the year 2003.

The IMF and Croatia came to a preliminary agreement on a new standby agreement worth USD 99 million. The key issues during the recent negotiations were soaring foreign debt and the ever-widening budget deficit. In order to combat further increases in foreign indebtedness, the Fund and Croatian authorities agreed, *inter alia*, on: (a) gradually reducing the general government deficit from 6.3% in 2003 to 4.5% in 2004 and to less than 4% in 2005, thereby necessitating a revision of the 2004 budget with effect from mid-July so as to achieve those targets; (b) funding the budget deficit, including extra-budgetary deficits, primarily from domestic sources in both 2004 and 2005; and (c) limiting the scope of public enterprises to incur major debts. Moreover, the new standby arrangement envisages stabilizing the foreign debt to GDP ratio at 77% (measured in euros). Although the change had been announced earlier this year, it was decided to postpone the reduction of the VAT rate from 22% to 20%. The new standby agreement is precautionary in nature; funds have been allocated, but will not be drawn upon. The arrangement is expected to enter into effect from August onwards.

Foreign debt continued to increase in 2004; by the end of March it had risen to EUR 20.4 billion: EUR 1.6 billion higher than at the end of last year. The major portion (36%) is owed by the state, whose share, however, is declining. The banks account for

about one third of the total foreign debt. This year Croatia faces a debt service burden of some USD 3.8 billion, about two thirds of which falls due in the second half of the year.

Foreign trade developed dynamically in the first four months of 2004. According to customs statistics, overall exports expressed in current euros expanded by about 13%, while imports grew by only 4%. Consequently, the trade deficit was somewhat lower than over the same period the previous year. The good export performance was mainly due to shipbuilding and electrical machinery and equipment manufacture. Exports to the Yugoslav successor states (excluding Slovenia), some CIS countries and the Baltic states grew appreciably, while those to the EU increased at below-average rates. As for imports, it is interesting to note that although still the single largest import item, car imports dropped for the first time after years of marked growth. Information on the 2004 current account developments is not yet available. Overnight stays by foreign tourists were up by 8% during the first four months of the year. This would suggest that earnings from tourism equivalent to at least the level of the prior year can be expected.

In April 2004 the European Commission recommended that accession negotiations be opened with Croatia. The Commission has come to the conclusion that Croatia is a functioning democracy with stable institutions guaranteeing the rule of law. However, it has also stressed the need for continued collaboration with the International Criminal Tribunal for the Former Yugoslavia and requested additional efforts pertaining to the return of refugees, improvements in minority rights, judicial reform, regional cooperation and the fight against corruption. As for the economic criteria, it was stated that Croatia can be regarded as a functioning market economy. Croatia was formally granted candidate status at the EU summit in June; accession negotiations will start at the beginning of 2005. As for a possible EU entry date, the British Minister for Europe, Denis MacShane, went on record with a statement to the effect that Croatia would join the EU 'certainly before the end of the decade, and hopefully, much sooner'.

GDP growth will lose momentum in 2004; wiiw expects a rise of some 3.2% supported by continued (public) investment activities. Additional impetus may well come from household consumption on account of higher wages and increased transfer payments. The official GDP target set by the Ministry of Finance for the current year is 3.5-4%; this seems a somewhat optimistic figure. Achieving the deficit target agreed upon with the IMF will become rather difficult as the planned increases in excise duties and cuts in the health sector will not be sufficient to offset the announced repayments of pension arrears. Assuming that the export trends observed during the first months of the year continue while tourism develops along the same lines as the previous year, the current account might close with a slightly lower deficit than in 2003. The European Council's decision to initiate accession negotiations might have a significant impact on the dynamics of the country's economy.

Table HR

## Croatia: Selected Economic Indicators

	1999	2000	2001	2002	2003 <sup>1)</sup>	2003 1st quarter	2004	2004 forecast	2005
Population, th pers., mid-year <sup>2)</sup>	4554	4437	4437	4443	4443	.	.	.	.
Gross domestic product, HRK mn, nom.	141579	152519	165640	176429	189883	43492	.	199900	210000
annual change in % (real)	-0.9	2.9	4.4	5.2	4.3	4.9	.	3.2	3.5
GDP/capita (EUR at exchange rate)	4102	4502	4998	5361	5651	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	7510	8050	8600	9270	9890	.	.	.	.
Gross industrial production <sup>3)</sup>									
annual change in % (real)	-1.4	1.7	6.0	5.4	4.1	4.6	5.6	4	4
Construction industry, hours worked <sup>3)</sup>									
annual change in % (real)	-7.7	-9.1	3.6	12.8	22.8	19.2	.	.	.
Consumption of households, HRK mn, nom.	81546	89637	98054	106027	111918	26928	.	.	.
annual change in % (real)	-2.9	4.2	4.5	6.6	4.1	4.9	.	2.5	3
Gross fixed capital form., HRK mn, nom.	33025	33281	36984	43674	52637	11691	.	.	.
annual change in % (real)	-3.9	-3.8	7.1	10.1	16.8	16.2	.	6	6
LFS - employed persons, th, avg.	1492	1553	1469	1528	1537	1538 <sup>4)</sup>	.	.	.
annual change in %	-3.4	4.1	-5.4	4.0	0.6	1.1 <sup>4)</sup>	.	.	.
Reg. employees in industry, th pers., avg.	299.5	291.9	287.2	281.0	282.6	280.5	274.2	.	.
annual change in %	-3.0	-2.5	-1.6	-2.2	0.6	-0.9	-2.3	.	.
LFS - unemployed persons, average	234.0	298.0	277.0	266.0	256.0	253 <sup>4)</sup>	.	.	.
LFS - unemployment rate in %, average	13.6	16.1	15.9	14.8	14.3	14.1 <sup>4)</sup>	.	14	13.5
Reg. unemployment rate in %, end of period	20.4	22.3	23.1	21.3	19.1	21.0	19.1	18.5	18
Average gross monthly wages, HRK	4551	4869	5061	5366	5623	5459	5832	.	.
annual change in % (real, net)	10.1	3.4	1.6	3.1	3.8	6.3	4.3	.	.
Retail prices, % p.a. <sup>5)</sup>	4.2	6.2	4.9	1.7	1.8	1.7	1.8	2	1.5
Producer prices in industry, % p.a.	2.6	9.7	3.6	-0.4	1.9	3.4	0.2	1	1
General governm.budget, IMF-def., % GDP									
Revenues	48.4	46.2	44.7	45.2	44.9	.	.	.	.
Expenditures	56.6	52.7	51.5	50.0	49.5	.	.	.	.
Deficit (-) / surplus (+), % GDP	-8.2	-6.5	-6.8	-4.8	-6.3	.	.	-4.5	-4
Public debt in % of GDP	.	51.1	51.6	51.6	52.7	.	.	55	56
Discount rate % p.a., end of period	7.9	5.9	5.9	4.5	4.5	4.5	4.5	.	.
Current account, EUR mn <sup>6)</sup>	-1312	-498	-810	-2035	-1806	-999	.	-1500	-1400
Current account in % of GDP	-7.0	-2.5	-3.7	-8.5	-7.2	.	.	-5.7	-5.1
Gross reserves of NB excl. gold, EUR mn	3012.6	3783.2	5333.6	5651.3	6554.1	5782.2	6178.5	.	.
Gross external debt, EUR mn	9937.2	11865.2	12830.6	14813.7	18893.1	15830.4	19619.7	.	.
FDI inflow, EUR mn <sup>6)</sup>	1377	1180	1743	1193	1518	316	.	.	.
FDI outflow, EUR mn <sup>6)</sup>	44	4	173	566	55	21	.	.	.
Exports of goods, BOP, EUR mn <sup>6)</sup>	4124	4951	5313	5312	5569	1386	.	5800	6000
annual growth rate in %	1.0	20.1	7.3	0.0	4.8	15.5	.	4	3
Imports of goods, BOP, EUR mn <sup>6)</sup>	7219	8424	9892	11309	12587	2739	.	13000	13500
annual growth rate in %	-6.4	16.7	17.4	14.3	11.3	12.4	.	3	4
Exports of services, BOP, EUR mn <sup>6)</sup>	3494	4440	5443	5911	7639	783	.	.	.
annual growth rate in %	-1.1	27.1	22.6	8.6	29.2	11.8	.	.	.
Imports of services, BOP, EUR mn <sup>6)</sup>	1968	1982	2175	2561	2640	531	.	.	.
annual growth rate in %	16.9	0.7	9.7	17.7	3.1	-5.6	.	.	.
Average exchange rate HRK/USD	7.11	8.28	8.34	7.86	6.70	7.07	6.09	.	.
Average exchange rate HRK/EUR (ECU)	7.58	7.63	7.47	7.41	7.56	7.58	7.61	7.6	7.6
Purchasing power parity HRK/USD, wiiw	3.80	3.90	3.96	3.96	4.03	.	.	.	.
Purchasing power parity HRK/EUR, wiiw	4.14	4.27	4.34	4.28	4.32	.	.	.	.

Notes: 1) Preliminary. - 2) From 2000 according to census March 2001. - 3) Enterprises with more than 20 employees. - 4) First half-year of 2003. - 5) From 2002 consumer prices, % p.a. - 6) wiiw calculated from USD.

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