Country report

CROATIA

Summary
The Croatian economy is slowly recovering from the global crisis that hit the economy in 2009. The crisis further worsened the country's twin deficits and external debt increased to 101% of GDP (2010). Moreover, unemployment rose from 15.1% in 2007, to 17.6% in 2010. For 2011, we expect GDP growth to reach 1.5%. Drivers of growth include recovering domestic demand and an increase in tourism. Meanwhile, public policy centres on Croatia's wish to become an EU member. Although the country has yet to meet all the criteria for accession, it hopes to join the EU by 2012.

Things to watch:

- High public and external debt levels
- Structural current account and budget deficits
- Negotiations on EU accession

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Croatia

National facts			Social and governance indicators			rank / total
Type of government	Democratic Republic		Human Development Index (rank)			51 / 169
Capital	Zagreb		Ease of doing business (rank)			84 / 183
Surface area (thousand sq km)	57		Economic freedom index (rank)			82 / 179
Population (millions)	4.4		Corruption perceptions index (rank)			62 / 178
Main languages	Croatian (96%)		Press freedom index (rank)			62 / 178
	Serbian (1%)		Gini index (income distribution)			29
Main religions	Roman Catholic (88%)		Population below $1.25 per day (PPP)			2%
	Orthodox (4.4%)		**Foreign trade**			**2010**
	Muslim (1.3%)		*Main export partners (%)*		*Main import partners (%)*	
Head of State (president)	Ivo Josipovic		Italy	19	Italy	15
Head of Government (prime-minister)	Jadranka Kosor		Bosnia	12	Germany	13
Monetary unit	kuna (HRK)		Germany	10	Russia	9
Economy			Slovenia	8	China	7
Economic size	*bn USD*	*% world total*	*Main export products (%)*			
Nominal GDP	60	0.10	Machines & transport equipment			32
Nominal GDP at PPP	78	0.11	Manufactures			27
Export value of goods and services	25	0.13	Mineral fuels & lubricants			12
IMF quotum (in mln SDR)	365	0.17	Food & live animals			9
Economic structure	*2010*	*5-year av.*	*Main import products (%)*			
Real GDP growth	-1.4	2.2	Machines & transport equipment			29
Agriculture (% of GDP)	7	6	Manufactures			25
Industry (% of GDP)	27	28	Mineral fuels & lubricants			19
Services (% of GDP)	66	65	Chemicals			14
Standards of living	*USD*	*% world av.*	*Openness of the economy*			
Nominal GDP per head	13459	137	Export value of G&S (% of GDP)			41
Nominal GDP per head at PPP	17332	148	Import value of G&S (% of GDP)			42
Real GDP per head	10401	130	Inward FDI (% of GDP)			3.0

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Croatia is generally regarded as one of the richer and more developed countries of former Yugoslavia. With a real GDP per head of USD 13459 it falls somewhere between a middle and high income country. Croatia's natural wealth guarantees a steady inflow of tourists. Tourism services combined with financial and transport services, together account for 67% of GDP, making for a services-based economy. In addition, the industrial sector makes up 27% of GDP. Shipbuilding forms an important element of industrial production. Finally, a smaller agricultural sector accounts for 7% of GDP and exports, among others, wines, biological food products and blue water fish.

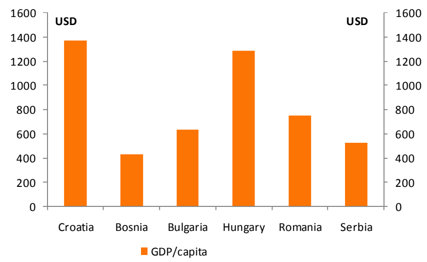
In 2009, the global crisis hit the Croatian economy on the demand side. The crisis in Europe, Croatia's main export market, lowered external demand for tourism services, as well as industrial exports. Moreover, reduced availability of foreign capital constrained credit available to the private sector, thereby affecting domestic demand. The result was a two-year long recession. The economy contracted by 5.8% in 2009 and a smaller 1.4% in 2010. Moreover, unemployment rose from 14.9% in 2009 to 17.6% in 2010.

Economic recovery will be slow in 2011, as high unemployment, slow wage growth and constrained credit growth will continue to dampen private consumption. Although credit conditions improved somewhat over the last year, consumption growth will likely stay below pre-crisis levels. Moreover, a planned restructuring of the shipyards will result in further job losses. Finally, with external demand only slowly recovering, we should not expect any major increases in exports of goods and services . Consequently, in 2011, GDP growth will not exceed 1.5%.

For the medium to long run economic growth will be determined by developments in a number of fields. For one, much sought after accession to the EU, will likely create further growth opportunities. However, there are also some factors that could obstruct future productivity. These

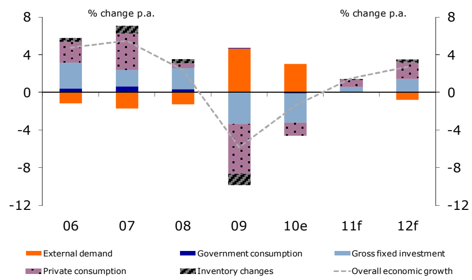
include the country's persistent corruption and relatively high unemployment levels. Future growth rates also depend on the government's ability to mitigate the effects of an ageing population. Much like western European countries, Croatia is experiencing the consequences of an ageing labor force. Between 2011 and 2020 the labor force will contract by 0.5% each year. This development will impact productivity, while simultaneously raising costs of health care, pensions and so on. Finally, economic growth will also depend on the ability of the government to create a competitive export sector. At this moment, high wage levels, high taxes and a strong currency continue to reduce competiveness, as well as Croatia's attractiveness as a production center.
Croatia's banking sector weathered the crisis relatively well. Deposits remained more or less stable and banks remained sufficiently capitalized. Nonetheless, the crisis did cause a drop in profits, as well as a reduction in loans to the private sector.

Chart 1: Income level



Source: EIU

Chart 2: Growth performance



Source: EIU

Political and social situation

Croatia is governed by a coalition of the country's largest party, the Croatian Democratic Union (HDZ), the Croatian Peasant Party (HSS) and several independent parliamentarians. In light of the economic recession, the coalition has come under increased scrutiny. Voters are increasingly questioning economic policies, but are also accusing the government of fostering an environment of corruption. Corruption is indeed a persistent problem. In addition, high income inequality and increasing unemployment also inspire criticism.
The government has so far survived the multiple demonstrations and calls for early elections. Nonetheless, it is far less certain that the coalition will also survive the upcoming parliamentary elections in November 2011. In fact, it is expected that the largest opposition party, the Social Democratic Party (SDP) will take over control. In such a scenario, a centre-left coalition would replace the current centre-right coalition. Nonetheless, as a large percentage of voters are still undecided, we should not jump to conclusions.
Croatia's foreign policy centers on the issue of EU accession. Croatia already applied for accession eight years back. However, border conflicts with Slovenia, weak competition policies, a lack of agricultural development, corruption, as well as a weak judiciary system have so far obstructed Croatia's accession. Border conflicts motivated Slovenia to vote against Croatia's accession in 2009. Since then the issue between the two countries has been resolved and should not stand in the way of future negotiations. However, failure to battle corruption and implement the required judiciary reforms, remain important obstacles. Given the magnitude of these obstacles, we do not expect Croatia to make its deadline and get accepted in June. It should, however, be able to gain acceptance by 2012.

Economic policy

The government's main economic policy goal is to curtail public spending, reduce the excessive red tape and improve overall competitiveness. In the past year it has introduced a number of reforms to attain this goal. These include the planned lay-off of civil servants, as well as a wage and pension freeze in the public sector. Nonetheless, execution has been slow and both the World Bank and the EU have urged for faster implementation of the reforms. In light of the upcoming elections and the government's loss of support, we fear that 2011 will see little progress in these areas. In contrast, we do expect the government to finally privatize its shipyards (which are running at a loss), as doing so will bring Croatia one step closer to EU accession.

High and inefficient fiscal spending (42% of GDP, 2010) is a major concern. On the one hand, the high tax rates needed to finance the public expenditures are weighing down the overall competitiveness of the private sector. During the crisis, instead of relieving some of the pressure on the private sector, the government augmented corporate taxes by 4 percent points. Although this crisis tax was recently abolished, tax levels are still the highest in the Balkans. Moreover, high taxes provide little incentive for the 17% of the population, working in the informal sector, to join the formal economy.

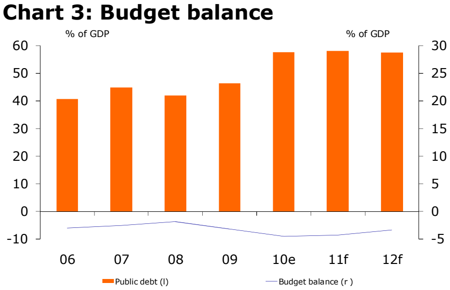
On the other hand, high fiscal spending is driving up the already substantial public debt, as well as the fiscal deficit. During the crisis the deficit reached 4.5% of GDP in 2010 (from 1.8% of GDP in 2008). For 2011, we expect the deficit to remain relatively high at 4.3% of GDP. High fiscal deficits added to public debt, which rose from 42% of GDP in 2008 to 58% of GDP in 2010. As we expect expenditures to remain around their 2010 level, an expected GDP growth rate of 1.5% will do little to reduce the debt to GDP ratio. Consequently, we expect public debt to remain at 58% of GDP in 2011.

So far, the government has been able to meet its financing needs. Despite a recent downgrade by S&P, which put Croatia one notch above junk, the government was still able to sell a USD 1.5bn bond last March. However, in order to finance this year's budget deficit and roll over existing debt it will need to find financing for an additional USD 2bn.

As public measures to stimulate growth yielded little results, the central bank of Croatia began to implement monetary stimulus measures to foster growth. Its main (attempted) contribution to economic recovery was a reduction of the reserve requirement, to help spur credit growth. Nonetheless, credit growth has been slow. In the meantime, inflation has begun to rise, on the back of increased international food and fuel prices. The increase in inflation will force the central bank to limit further attempts to induce credit growth. That said, inflation is still sustainable and is expected to average 2.5% in 2011 (from 1.1% in 2010).

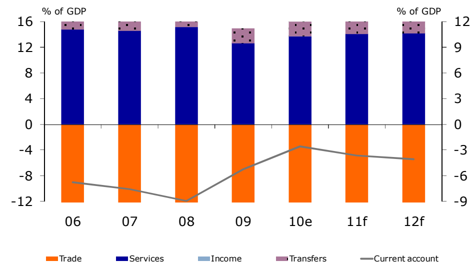
Another important goal of the central bank is to smooth the exchange rate of the kuna against the euro. In the past year, the bank's interventions were successful in stabilizing the rate and we only saw some minor depreciation. For the coming year, we expect a similar picture, as the central bank still holds plenty of foreign exchange reserves to manipulate the exchange rate. Nonetheless, changes in investors' sentiment (i.e. capital flight) could put pressure on the exchange rate, as will a deteriorating current account balance. Moreover, exporters may call on the central bank to depreciate the kuna, so as to improve the competitiveness of the export sector. However, doing so would impact borrowers who have to repay debt denominated in foreign currencies. Hence, the central bank will continue to balance the interests of both.

Chart 3: Budget balance



Source: EIU

Chart 4: Current account balance



Source: EIU

Balance of Payments

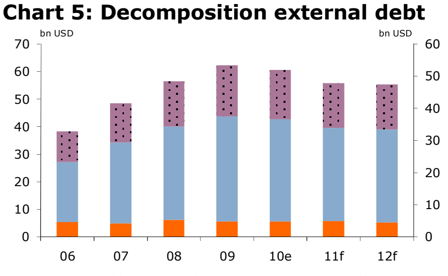
Croatia has a structural deficit on the current account which became as high as 9% of GDP in 2008. Since then, the deficit has narrowed, reaching 2.6 % of GDP in 2010. For 2011, we expect the current account deficit to widen to 3.6% of GDP, due to rising fuel prices and legging external demand.

The main contributor to the current account deficit is a structural trade deficit. The deficit reflects the lack of competitiveness of Croatia's export sectors, as well as strong domestic demand for capital goods. In 2010, reduced domestic demand translated in a somewhat reduced trade deficit of 14.5% of GDP (from 16.3% of GDP in 2009). Nonetheless, for 2011 we expect the deficit to widen on the back of recovering domestic demand and a slow recovery of Croatia's main export markets, most notably Italy and Bosnia.

One of the main sources of foreign exchange is Croatia's large tourism sector. During the global crisis many tourists stayed away and Croatia reported a somewhat smaller surplus on the services balance. For 2011, we expect a small increase in the number of tourists reaching Croatia and thus an increase of the services surplus to USD 8.4bn (from USD 8bn in 2010).

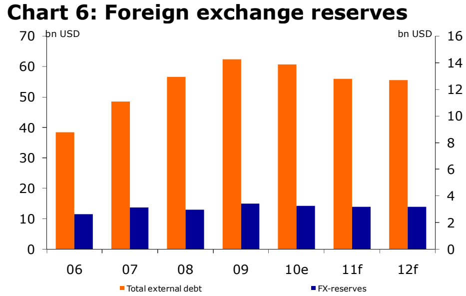
A deficit on the income balance is the result of the repatriation of profits by foreign investors, as well as interest payments. In contrast, the transfer balance generally reports a small surplus, reflecting the inflow of EU funds.

Chart 5: Decomposition external debt



Source: EIU

Chart 6: Foreign exchange reserves



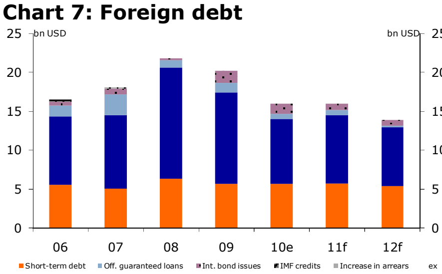
Source: EIU

Although a structural current account deficit is worrisome, there are some mitigating factors. For one, Croatia mostly imports capital goods, instead of consumption goods. A more important factor is the fact that the current account deficit is still lower than the net amount of foreign direct investments (3% of GDP in 2010). Foreign direct investments guarantee a steady inflow of foreign exchange reserves, which are less prone to changes in market sentiment than for instance portfolio investments. Consequently, for 2011, foreign exchange reserves are expected to cover 6.1 months of imports (a decrease from the 6.8 months in 2010). Still, in order to improve the current account balance and also attract investors in the medium to long run, the government should take measures to enhance the country's overall competiveness.

External position

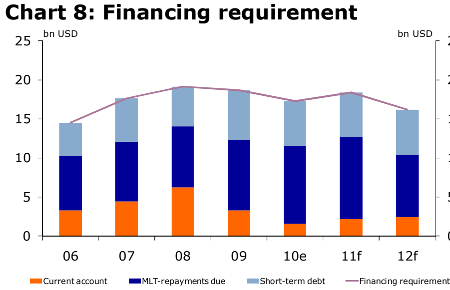
Croatia's external position constitutes one of the largest risks to the country's overall stability. In 2010, external debt rose to 100% of GDP. For 2011, we expect this ratio to fall to a still high 94% of GDP. The situation is especially worrisome in light of the recent downgrade by S&P which could be indicative of an overall change in investors' sentiment. Moreover, although the downgrade only concerns sovereign debt, it is feared that it will also affect the borrowing costs of private borrowers. Together, private borrowers issued roughly 75% of all external debt. On a brighter note, Croatia's private and public sectors have so far been able to find funding in the market. This enabled Croatia to survive the global crisis without having to call on the IMF. In contrast, between 2008 and 2010, foreign exchange reserves rose from roughly USD 13bn to USD 14bn. For 2011, we expect foreign exchange reserves to cover 78% of all debt service due (from 80% in 2010). This includes short term debt, which currently accounts for nearly 10% of total external debt.

Chart 7: Foreign debt



Source: EIU

Chart 8: Financing requirement



Source: EIU

Croatia

Selection of economic indicators	2006	2007	2008	2009	2010e	2011f	2012f
Key country risk indicators							
GDP (% real change pa)	4.7	5.5	2.4	-5.8	-1.4	1.5	2.7
Consumer prices (average % change pa)	3.2	2.9	6.1	2.4	1.1	2.5	2.6
Current account balance (% of GDP)	-6.8	-7.6	-9.0	-5.2	-2.6	-3.7	-4.1
Total foreign exchange reserves (mln USD)	11488	13675	12957	14895	14133	13860	13860
Economic growth							
GDP (% real change pa)	4.7	5.5	2.4	-5.8	-1.4	1.5	2.7
Gross fixed investments (% real change pa)	10.9	6.5	8.2	-11.8	-11.6	2.0	5.5
Private consumption (% real change pa)	3.5	6.2	0.8	-8.5	-2.3	1.2	3.0
Government consumption (% real change pa)	2.2	3.4	1.9	0.2	-0.5	0.7	0.5
Exports of G&S (% real change pa)	6.5	4.3	1.7	-16.2	6.0	3.5	3.3
Imports of G&S (% real change pa)	7.4	6.5	3.6	-20.7	-1.3	3.0	4.6
Economic policy							
Budget balance (% of GDP)	-3.0	-2.5	-1.8	-3.2	-4.5	-4.3	-3.3
Public debt (% of GDP)	41	45	42	46	58	58	58
Money market interest rate (%)	2.5	5.1	6.1	7.5	1.0	1.9	3.1
M2 growth (% change pa)	18	18	4	-1	2	7	8
Consumer prices (average % change pa)	3.2	2.9	6.1	2.4	1.1	2.5	2.6
Exchange rate LCU to USD (average)	5.8	5.4	4.9	5.3	5.5	5.8	6.1
Recorded unemployment (%)	16.9	15.1	13.4	14.9	17.6	17.2	15.8
Balance of payments (mln USD)							
Current account balance	-3313	-4445	-6251	-3315	-1561	-2190	-2440
Trade balance	-10487	-12933	-15956	-10290	-8740	-9660	-10160
Export value of goods	10644	12623	14460	10736	12183	13140	13480
Import value of goods	21131	25556	30416	21026	20922	22790	23640
Services balance	7252	8563	10571	8015	8271	8420	8520
Income balance	-1468	-1505	-2392	-2491	-2502	-2400	-2360
Transfer balance	1390	1431	1526	1450	1409	1460	1570
Net direct investment flows	3194	4636	4696	1645	1400	2400	2500
Net portfolio investment flows	-364	-70	-830	-1584	-800	-150	-200
Net debt flows	5297	4901	8968	4854	263	-220	180
Other capital flows (negative is flight)	-2127	-2836	-7300	336	-64	-110	-40
Change in international reserves	2687	2187	-717	1937	-762	-270	0
External position (mln USD)							
Total foreign debt	38355	48584	56491	62417	60730	55950	55480
Short-term debt	5572	5099	6372	5726	5698	5770	5450
Total debt service due, incl. short-term debt	13157	17036	15782	17198	17434	17820	15360
Total foreign exchange reserves	11488	13675	12957	14895	14133	13860	13860
International investment position	-39581	-58019	-49584	-56222	n.a.	n.a.	n.a.
Total assets	23903	31799	31962	35299	n.a.	n.a.	n.a.
Total liabilities	63484	89818	81547	91520	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-21.4	-22.1	-22.9	-16.3	-14.5	-16.1	-17.0
Current account balance (% of GDP)	-6.8	-7.6	-9.0	-5.2	-2.6	-3.7	-4.1
Inward FDI (% of GDP)	7.0	8.5	8.6	4.7	3.0	4.7	4.8
Foreign debt (% of GDP)	78	83	81	99	101	94	93
Foreign debt (% of XGSIT)	156	167	166	240	216	188	182
International investment position (% of GDP)	-80.7	-99.0	-71.2	-88.9	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	53	59	46	66	62	60	50
Interest service ratio incl. arrears (% of XGSIT)	5	10	5	6	5	5	4
FX-reserves import cover (months)	5.6	5.6	4.4	7.2	6.8	6.1	5.8
FX-reserves debt service cover (%)	87	80	82	87	81	78	90
Liquidity ratio	110	111	107	113	113	108	113

Source: EIU