



The World Bank

# EU10 Regular Economic Report

## Croatia Supplement

October 2008

### Key Messages

- Croatia has faced the initial impact of the global financial crisis well prepared. Appropriate policies (both monetary and prudential ones) taken well in advance to create the adequate liquidity reserves in the banking system helped withstand financial market disturbances. A government measure to increase guaranteed deposits' amount to EUR 56,000 as well as the establishment of the Stability Fund by non-bank financial institutions are equally important in these volatile times to secure depositors' trust and confidence in the financial system.
- Weaker foreign demand and the ongoing financial turbulence will affect the growth slowdown in the region as well as Croatia at the end of 2008 and 2009. This will put pressure on fiscal balances in many countries, while the most affected will be the ones that were running pro-cyclical policies in the past. For Croatia, stronger expenditure restraint remains essential for sustaining and strengthening the ongoing fiscal consolidation process and allowing for future tax cuts. Risks ahead for consolidation in terms of external environment and potential growth slowdown need to be taken seriously.
- The uncertainties surrounding the outlook, induced by global developments will make external imbalances more difficult to finance, cost-wise and access-wise. Significant frontloaded expenditure-led fiscal adjustment is thus essential, to address external vulnerabilities as well as inflation. However, the importance of properly funding and targeting social protection programs for the most vulnerable should remain a priority.
- Factors from the international environment have a considerable effect on stabilizing inflation and the structure of relative prices. The recent rapid growth in food, oil and commodity prices, however, has not disappeared forever. In 2008, around three-fourths of inflation in Croatia was imported, so the reactions of the central bank and fiscal policy, although limited, remain crucial for 2009 and beyond.
- Croatia should also prepare for the time when financial conditions return to normal not to allow for protracted growth convergence. This will require deepening structural reforms to reduce vulnerabilities, improve investment climate and increase total factor productivity, and closely following future developments in monetary conditions as volatility declines, intensifying banking supervision.

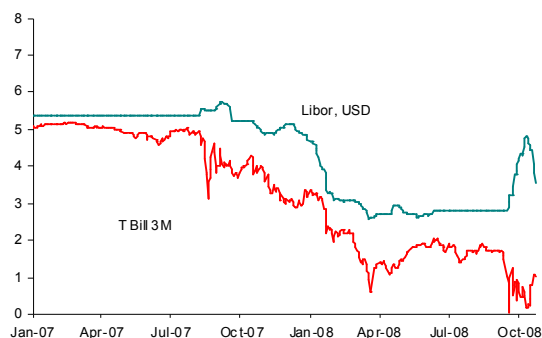
## External Environment

*The international financial crisis has intensified in early October, resulting in a freezing of interbank markets, substantial tightening of credit conditions and numerous bank failures and takeovers in developed economies. Equity prices have dropped sharply in both developed and emerging economies, while volatility has increased dramatically for equities, commodities and currencies. The policy response notwithstanding, the financial dislocations thus far make it likely that growth in developed and emerging economies will be substantially weaker this year and next.*

The full impact of the financial turbulence on the EU10 and Croatia is yet to be realized and substantial uncertainty remains, given the rapidly changing international environment and rapidly changing macroeconomic and financial conditions. The direct impact on the EU10's and Croatia's financial systems through exposure to "toxic" securities appears to be insignificant. However, the indirect effect is likely to be substantial through the slowdown in global demand for the region's exports, the tighter financial conditions and the possibility of contagion. Countries with larger external financing needs will be experiencing tighter external financing conditions.

Authorities are encouraged to begin reversing the pro-cyclical tendencies in fiscal policies through cutting unproductive investments, keeping the wages under control and create savings wherever possible. At a time when citizens are coming under pressure from the increased share of outlays on food in household budgets (given the earlier increase in food prices) and weaker economic activity, governments will be well advised to sustain, and where needed, better target social safety nets.

**Figure [1]. 3-month US Treasury Bill and 3-month LIBOR (in percent)**



Source: CSOs.

**Table [1]. Global economic growth (in percent)**

	Real GDP Growth			
	2007	2008f	2009f	2010f
World	3.7	2.8	1.3	3.2
U.S.	2.0	1.7	0.2	2.1
Eurozone	2.6	1.3	-0.4	1.7
Japan	2.0	1.0	-0.1	1.9

Source: World Bank.

There may be some scope for monetary easing in some countries to alleviate the impact of the turbulence should liquidity issues begin to emerge. Scope for monetary easing will be larger in countries that have been able to control better inflation thus far. In case of contagion emanating from cross-border banks and cross-border lending, cooperation between home and host supervisory authorities is essential.

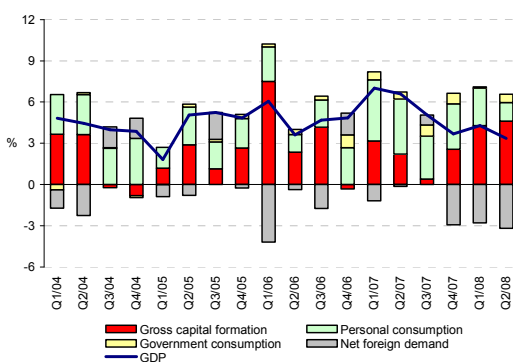
Countries should also prepare for the time when financial conditions return to normal. This will require deepening structural reforms to reduce vulnerability, including tightening fiscal policy where it has been lax during good times, particularly where inflation is in double digits, closely following future developments in monetary conditions as volatility declines, intensifying banking supervision, and improving the investment climate (competition, skills, infrastructure, governance) to attract non-debt creating flows to meet external financing requirements.

## Output Developments

Growth is likely to slow in almost all countries due to weak external demand and tight financial conditions, with projections subject to substantial uncertainty. Baltic countries are already facing recessionary environment. Moreover, weakness in external demand and deteriorating financial performance of enterprises may well result in a decline in investment growth.

In H1 2008, GDP in Croatia grew by 3.8 percent relative to the same period last year, when total economic activity grew by 6.8 percent. Gross fixed capital formation was the strongest economic growth generator, rising at an exceptionally high rate of 11.3 percent during H1 2008 thus contributing to total GDP growth with 3.6 percentage points. It was the expansion of private investment in non-residential buildings there was behind this exceptional growth. However, in view of declining leading indicators of construction activity in H1 2008, as well as buoyant stocks of intermediate products, construction works volume is expected to slow down towards the end of the year. Personal consumption recorded 3.2 percent y/y growth in January-June period, a slowdown against 6.8 percent in the same period last year. A slowdown was mainly due to a decline in real net wages and credits to households. A sizeable negative contribution to real GDP growth from net foreign demand in H1 was due to weaker export performance (4.3 against 6.3 percent in H1 2007) followed by growing imports at 7.6 percent rate.

**Figure [3]. GDP growth rates (in %) and relative contribution of demand categories, in percentage points**

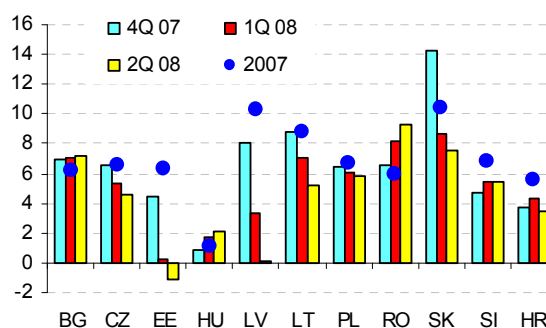


Source: CBS

On the supply side, total GVA rose by 4.4 percent in H1 2008, compared to a considerable growth recorded in the same period last year (6.6 percent). Construction, transport, communications and financial intermediation were sectors with the largest activity rise. Q2 has seen agriculture, hunting, forestry and fishing reporting acceleration (to 3.5 percent y/y from 0.6 percent y/y in Q1).

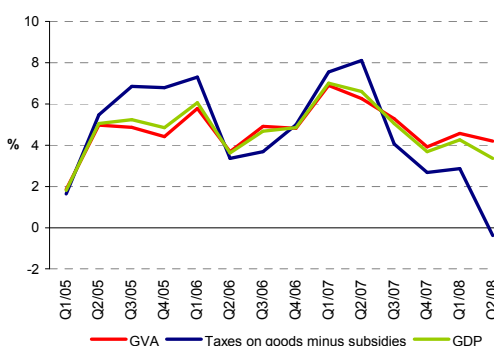
High frequency data point to a growth slowdown below the 4-percent rate by year-end. Weaker domestic and external demand aggravated by the inflationary pressures from food and energy prices, and global financial turmoil impacting the real sector will subdue growth

**Figure [2]. GDP growth rates (% yoy)**



Source: CSOs.

**Figure [4]. GDP, GVA and Taxes on goods minus subsidies, real year-on-year rate of growth**



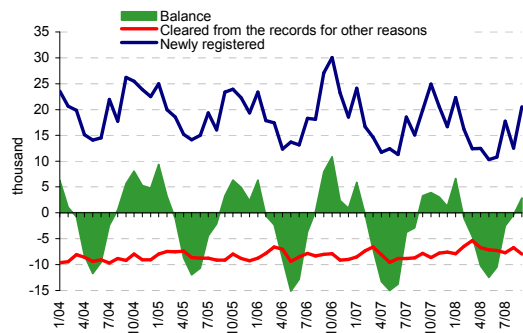
prospects beyond 2008. Industrial production grew by a mere 0.2 percent y/y in Q3, with construction activities and retail trade losing breath already in August. Tighter financial conditions at the end of 2008 and 2009 may dampen private investment activity, likely leading to a further downward adjustment in output growth in 2009 towards 3.5 percent.

### Labor market developments

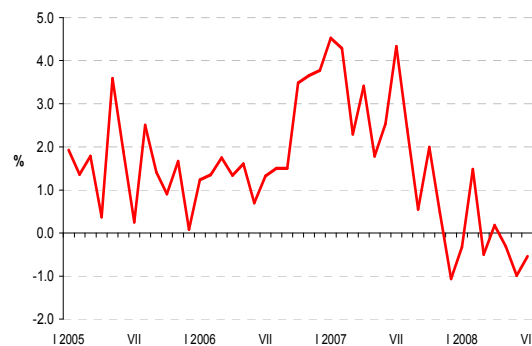
*The slowdown in economic activity has had little impact on the region's labor markets thus far. However, low unemployment and high inflation has fed into wage pressures in most of the EU10 countries. Sustained skill shortages and low internal mobility, in particular in the larger countries, are also an important factor that has added to wage pressures.*

**In Croatia, favorable labor market trends continued in 2008.** The latest survey-based unemployment rate stood at 10.2 percent in Q1 2008, compared to 11.4 percent in Q1 2007. Women encountered higher jobless rate at 12.1 percent than men, at 8.6 percent. However, LFS unemployment rate is still somewhat lower than the administrative one, indicating that the certain number of persons registered with the Croatian Employment Service is either employed in the unofficial economy or is not among active job-seekers. The official unemployment rate after declining since January slightly increased to 12.6 percent in September or 222,217 people. This still presents an annual decline of 1.5 percentage points or a drop in the number of unemployed by 9.7 percent y/y. Despite a small decrease in demand for workers in tourism, new employment was registered in agriculture, trade, mining and public service indicating that these sectors might become a larger absorber of potentially increased unemployment in sectors affected by the global slowdown. Given the labor market rigidities, this should be of a smaller scale than in more labor market liberalized economies.

**Figure [5]. Changes in registered unemployment**



**Figure [6]. Average real net wage, y/y growth rate**



Sources: CES, CROSTAT

**Real net wages continued declining in Q3 as well as labor productivity.** Net salary grew by nominal 6.5 percent in August, but fell by real 0.6 percent y/y under the impact of increased inflation. Nominal net salary stood at 5,184 kuna in August or EUR 725. The growth of net wages outperformed the growth of gross wages, reflecting the Personal Income Tax changes which increased tax-exempt income from 1,600 to 1,800 kuna, effective from July 2008. Labor productivity growth in industry slowed down to 4.2 percent in the first eight months of 2008 from somewhat higher rates of growth recorded earlier in the year. The highest growth in productivity was seen in production of non-durable consumer goods and energy.

### Inflation and monetary policy

*Inflation has begun to decline in most countries in the region, after price increases surged in early 2008 because of higher prices for food and imported energy. The ongoing financial turmoil and slowing global growth are complicating policy-makers' choices with price levels remaining high.*

Consumers' purchasing power continues to be eroded by high inflation and the effects are spilling over into retail sales. Although inflation in Croatia may well have peaked at 8.4 percent in July, consumption spending is unlikely to bounce back strongly. The rate retreated to 6.4 percent in September, and should ease further over the rest of the year as food and fuel prices decline. The slowdown was a result of cheaper food (bread and cereals, oils and fats, fruits and vegetables) and oil prices moderation. In addition, some of the retail chains started to cut prices of some basic products and cattle food, the effect of which will kick-in in the coming months. Prices of housing and utilities also grew at a slower pace than a month earlier, which was mainly due to the lower prices of liquid fuels and mild heating season. Producer prices on the domestic market rose by an average of 9.1 percent in the first nine months of 2008, or 6.3 percentage points more than in the same period of previous year. The main factor for acceleration of producer prices was energy, which rose by an average 13 percent in January-September, as a reflection of the Government decision to allow for a 20-percent increase in the electricity prices.

With cumulative annual inflation at 6.7 percent in September, the annual projection stands at 6.3 percent, considering (i) no new external shocks will appear from global food and energy prices, (ii) no corrections of gas administered prices and (iii) continuation of appreciation pressures. Due to a high base effect, the CPI inflation will continue declining in 2009 towards 4 percent y/y. Factors from the international environment have a considerable effect on rising inflation and the structure of relative prices, particularly the rapid growth in food and commodity prices, and the price of oil. Around two thirds of inflation is in fact imported, so the reaction of the central bank, but most of all fiscal policy is crucial.

Figure [7]. REER (CPI) 2001=100

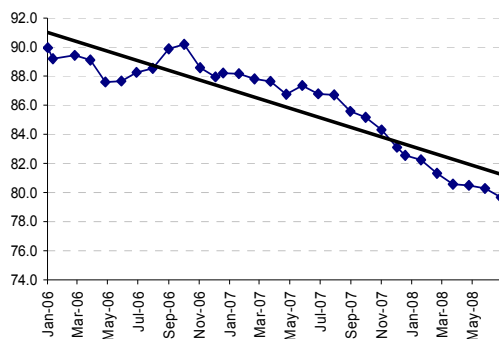
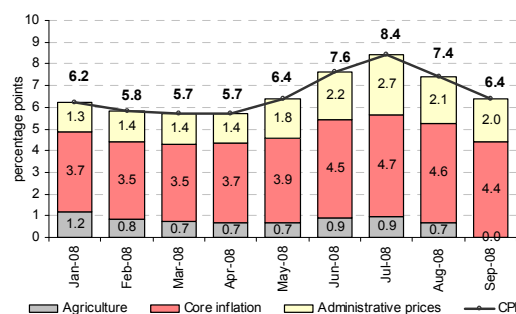


Figure [8]. Contributions to CPI Growth



Sources: CNB, CROSTAT

The tighter financial conditions, growing concerns about credit risk amid the intensifying global financial crisis and weakening economic expansion have resulted in slower growth in domestic credit in most countries. In Croatia, domestic credit growth remains stable influenced by the credit ceilings imposed by the CNB already in 2007 and maintaining of he adequate liquidity at interbank market.

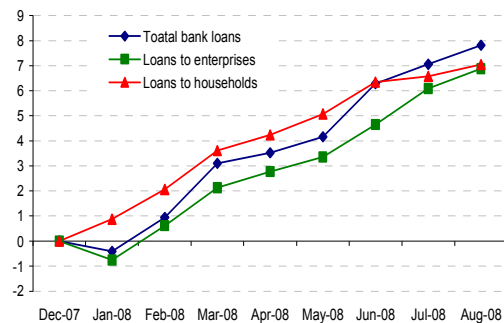
At the end of August, bank placements to the non-banking sector increased by 11.4 percent y/y, largely due to households' credits. Total bank placements to corporate sector continued to slow down, substituted by a diversion to direct borrowing from abroad. Thanks to the combination of monetary, administrative and supervisory measures, aimed at reducing both macroeconomic and financial vulnerabilities, recent data indicate a slowdown in foreign-currency lending to 61.7 percent of total in August 2008.

The Central Bank abolished the marginal reserve requirement of 55 percent in early October, thus releasing approximately EUR450 million to the banking system in order to ensure foreign currency liquidity. The MRR, introduced four years ago, aimed to slow down extensive foreign borrowing by banks. Indeed, external debt of the banking sector declined from EUR 10 to 7 billion. Liquidity of the banking sector has been maintained in the aftermath

of global crisis through reversed repo auctions that would soon be broadened to state bonds, going beyond the T-bills which were used as the main collateral so far. The O/N interbank rates have stabilized as well although at the higher level (at around 8 percent) than in September.

Although Croatia has been relatively unscathed by turbulence in the global financial markets, except for the capital market which slid by 28 pct in the first three weeks of October, continued global market turmoil highlights the need for effective contingency planning. Croatia's banks had very limited direct exposure to the subprime market developments, and parent banks do not appear to have changed their willingness to fund or withdraw their asset from Croatian subsidiaries. Nevertheless, the authorities have taken steps to initiate formal communications on contingency planning with supervisory authorities of foreign banks. Banks' profitability remains satisfactory, and capital adequacy and asset quality are currently at comfortable levels. Croatia's banks earned HRK 3.8 billion by the end of August this year, which is an increase of 27.6 percent y/y. Total assets of the banking system have increased by 7.3 percent y/y by August.

Figure [9]. Credit growth developments, in percent (compared to December 2007)



Past central bank measures have restrained excessive credit growth and foreign debt build-up still well ahead of the crisis outburst; on the other hand, they have ensured a build-up of liquidity reserves in the banking system that can help the system in withstanding prolonged international financial market disturbances. Lending standards will tighten further though and increase in interest rates could be expected. As the impact on the Croatian capital market widened, investors' money has started moving back into bank deposits, with banks offering higher deposit rates to attract deposits back.

### Public finance

*Fiscal developments in the EU10 countries and Croatia were mixed this year. This outcome reflects to a large extent buoyant revenues, thanks to higher growth (in Bulgaria, Hungary, Croatia and Romania), inflation and hikes in indirect taxes, all of these despite cuts in personal income tax rates in four out of eleven countries. Fiscal developments in 2009 will reflect the projected weaker economic expansion in all countries, slowing inflation and sustained pressure in many countries to compensate for this year's high price increases by boosting social spending. It is necessary to ensure that fiscal policies are not pro-cyclical, as they were in many of these countries during the times of strong economic growth. However, the extent of counter-cyclicality will largely depend on how much individual country could afford it.*

Fiscal consolidation has so far markedly benefited from strong revenue growth including in Croatia. However, a credible and sustainable fiscal adjustment process requires expenditure-led fiscal adjustment to address high refinancing needs, external vulnerabilities and inflation. This would include public sector wage restraint to keep the inflationary pressures under control, well targeted means-tested social benefits to vulnerable citizens to address the food and energy price impact on the living standard, and undertaking faster structural reforms that would raise confidence in successfully concluding EU accession negotiations and reducing vulnerabilities. Additional efforts in the area of public administration reform, strengthening judiciary and reducing administrative and tax burden to business are needed for raising Croatia's competitiveness.

Fiscal trends were mostly positive in the first half of 2008. On an annual level, revenues rose somewhat faster than expenditures, while government investment activity continued to

decrease. Consolidated general government revenues increased by 11.6 percent in the first six months of 2008, with largest contribution from VAT, social contribution and profit tax revenues. On the other hand, expenditures rose by 10.4 percent reflecting increases of expenditures on employee compensation, social benefits and the use of goods and services. Such trends led to a general government surplus of 0.2 percent of GDP. Still, as the revised budget projects that expenditures and acquisition of non-financial assets will pick up pace in

the second half of the year, a more complete estimate of public finance will be possible only when data for the entire 2008

**Table [2]. Fiscal developments**

(% of GDP)	2005	2006	2007	2008 Budget
				Revision*
Revenues w/o capital revenues	44.8	45.3	46.5	44.9
Expenditures	48.9	48.3	48.9	46.9
<b>Headline CGG deficit</b>	<b>-4.1</b>	<b>-3.0</b>	<b>-2.4</b>	<b>-2.0</b>

Sources: MoF, WB staff estimates. Note: GFS 1986 methodology; 2008 data without Croatian Highways, the deficit of which is 0.5 percent of GDP and additional expenditure of 3 percent of GDP.

become available. Public debt, without guarantees, totaled 43.6 percent of estimated GDP at end-June 2008. The contribution from the fiscal consolidation to a reduction of vulnerabilities will be important in 2008. Overall fiscal position, which in addition to the headline deficit includes off-budget items like the pensioners' debt repayment, HBOR as well as operations of the Croatian Highways into account, will improve in 2008. Namely, the overall fiscal deficit would, following the same approach, decline from 4.1 percent in 2007 towards 3.5 percent of GDP in 2008.

**The new Economic and Fiscal Policy Guidelines for 2009-2011 period adopted by the Government show continuation of fiscal adjustment in the medium term, which is without doubt an important factor for securing macroeconomic stability and reducing external vulnerabilities. Planned fiscal adjustment will reduce the total deficit from 1.6% of GDP in 2007 and turn it into surplus in the amount of 0.2% of GDP in 2011 (ESA 95 methodology). Thus, the current conjuncture poses special challenges for fiscal policy in the near and medium term.**

**Growth-induced revenue overperformance has improved Croatia's fiscal position in the past.** However, this will have to be replaced by expenditure-restrained policy in 2009; in particular, given the high public debt refinancing needs and the adverse global environment in 2009. The government announced a responsible approach in putting together the 2009 budget.

### **External vulnerability still high**

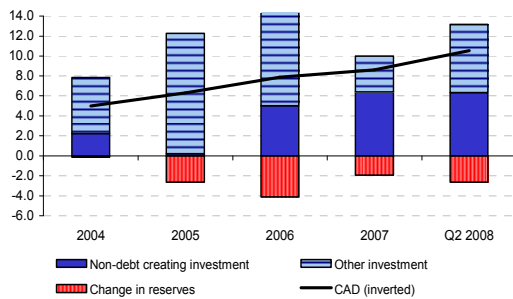
*Downward adjustment in the current account deficits in Estonia and Latvia has been substantial this year, but the Baltics, Bulgaria and Romania still have oversized external shortfalls. The looming global slowdown in economic activity makes it unlikely that further adjustments of current account deficits among the EU10 and Croatia can be driven by exports. It is likely that more sluggish domestic demand in the EU10 and Croatia as well as lower prices for imported energy and other commodities will help limit imports and help reduce imbalances.*

**Soaring global oil prices coupled with sluggish economic performance in Europe have adversely affected the foreign trade balance.** The Croatian CA deficit increased by 27.7 percent y/y in H1 2008, summing up to 10.5% of rolling GDP. The only improvement was seen in services balance, where the surplus increased by 17.4 percent y/y, mostly driven by high tourism revenues growth, while merchandise trade gap expanded by 21percent y/y due to soaring import of goods, particularly oil and capital goods, along with slowdown of exports. The eight-month trade deficit was EUR 14bn, which translates into 18.2 percent of GDP versus 17.4 percent a year earlier. Following these developments, the CA deficit is expected to increase to 9.6 percent of GDP at the end of 2008 to fall thereafter due to limited access to finance and

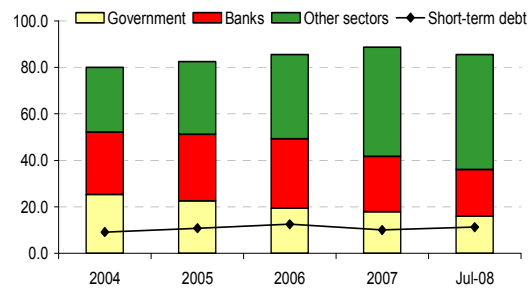
less costly import of oil and food the contribution of which to CAD rise was exceptional this year.

**Net capital inflows continued to exceed the external deficits, boosting further foreign exchange reserves and thus fairly mitigating upward pressures on exchange rates.** The CAD in the first six months was equally financed by foreign direct investments and loans taken abroad. Although FDIs amounted to EUR 1.8 billion in H1 2008, which a 17 percent drop in relation to the same period of 2007, they covered around 40 percent of external gap. Lower recapitalization of banks was mostly behind it. The recovery of FDIs is expected in the second half of the year after the acquisition of approximately 22 percent of INA Oil Company shares by the Hungarian MOL in October (amounting to app. EUR 870 mill). The total amount of FDIs can thus amount to over 6 percent of GDP.

**Figure [10]. CAD Financing, % of GDP**



**Figure [11]. External Debt, % of GDP**



Source: CNB

**Buoyant debt creating flows were reflected in rising gross external debt levels in 2008, although at a much slower rate.** Gross foreign debt in EUR terms increased to 86.3% of GDP in July. With the exception of banks, affected by the CNB lending restrictions, all remaining sectors contributed to the continuing rise of country's external debt, including corporate sector in the government ownership. Intercompany lending continued to grow due to an acceleration of direct external borrowing of enterprises and lending between mother and domestic banks. Government external debt is on a decline since 2004 and the short-term debt remains low.

**Worsening business conditions and tightened financing conditions could put some strain on the corporate sector's investment financing capacity.** Ensuring healthy financial deepening is therefore one of the main policy challenges ahead in the countries under review. Allowing for the rapid development of fully-fledged credit and deposit markets, without excessive risk-taking and without an excessive build-up of external vulnerabilities, will remain a difficult balancing act for policy-makers.