MACRO MONITORING REPORT
September 2016

CROATIA

In the first half of 2016 growth strengthened to 2.75 percent thanks to exports growth, accelerating private consumption, and a rebound of investment. The labor market continued to improve, with unemployment falling to 13 percent, the lowest level since summer 2008. Higher profits of foreign-owned companies and lower absorption of EU funds widened the current account deficit in Q1, while recovery of imports completely offset solid growth of exports. Despite continuing household and corporate deleveraging, there are mild signs of a bottoming-up in lending to corporate sector. Growth-supported fiscal consolidation brought the fiscal deficit down to 2 percent of GDP, which in turn brought public debt below 83 percent of GDP. New elections were set for September 11 as the political crisis ended with collapse of the government and dissolution of Parliament. Recognizing the downside risks to growth, rating agencies confirmed the current non-investment grade credit rating of BB with negative outlooks, as country plans refinancing of more than 13 percent of its external debt in 2017.

In Q2 growth strengthened further, to 2.8 percent, for the seventh consecutive quarter. The stronger than expected increase in GDP was a result of somewhat slower growth in exports of goods and services (4 percent y-o-y) and recovery of domestic demand. Accelerating household consumption (3.1 percent y-o-y), the highest investment growth in seven years (over 6.3 percent y-o-y), and a rise in general government consumption (2.6 percent y-o-y) more than offset the negative contribution from rising imports. Compared to the previous quarter, seasonally adjusted real GDP increased by 0.6 percent. Growth was broad-based, with encouraging performance from industrial production, retail trade, and robust tourist and construction activity.

Deflationary pressures have persisted in 2016 due to cuts in administrative prices. The strong annual decline of consumer prices by July (at 1.5 percent y-o-y) was considerably affected by the government cutting the natural gas price by 19 percent late last year; the cut could not be offset by the recovery of prices of services (in particular health and tourist services, responding to higher demand). Core inflation was again negative (at 0.1 percent y-o-y), for the second month in a row.

Figure 1. Growth in Real GDP, 2012 – 16, Percent)

Source: CBS.

As the economy recovered, the labor market continued to improve. The survey-based unemployment rate dropped to 15.4 percent in Q1 2016 (from 16.1 percent in Q4 2015). However, the activity rate went down to 51.1 percent and employment fell to 43.2 percent, far below the EU average. The administrative unemployment rate, however, continued declining, reaching 13 percent led by increased demand in the tourism sector, as well as employment in trade, manufacturing, and other service activities. More than 95 percent of new contracts are fixed-term employment. By June real gross wages had grown by 1.7 percent, partly because emigration of workers speeded up (over 9 percent of the unemployed left the country for jobs abroad). There are already shortages of low-skilled workers in construction, tourism, and other seasonal sectors.

The current account surplus, on a four-quarter basis, declined, but to a still high 4.3 percent of GDP. In Q1 2016 the current account deficit increased by 25 percent y-o-y, affected by a strong seasonal trade pattern and deterioration of the primary income balance due to the higher profits of foreign owned companies (especially those active in financial intermediation, hotels, and food and beverage production). In addition, inability to absorb all available EU funds was reflected in a worsening of the secondary income balance and also made significant contribution to the widening of the deficit. Robust growth of export of goods (6.6 percent y-o-y) was completely offset by rising imports of goods (4.3 percent y-o-y). In Q2 the trade balance continued to deteriorate as imports recovered despite stronger exports; however, the robust performance of tourism will help mitigate the widening trade deficit.

Net inflow of foreign direct investment (FDI) almost doubled. Net FDI increased to 0.7 percent of GDP on a 4-quarter basis, mainly because of higher retained profits by foreign-owned companies, especially banks. Over €503 mn more (27 percent y-o-y) was invested in Croatia in Q1 2016, the highest quarterly value since mid-2014. More than three-fourths of the FDI came from Austria, Luxembourg, and Germany.

External debt has stayed on its downward path in 2016: by May it had declined from 103.7 percent of GDP at the end of 2015 to 97.5 percent because of both deleveraging in the financial and other sectors and a reduction in government foreign liabilities. The net international investment position continued to improve, reaching 75.6 percent of GDP in Q1 2016, down from its peak of 93 percent in 2010.

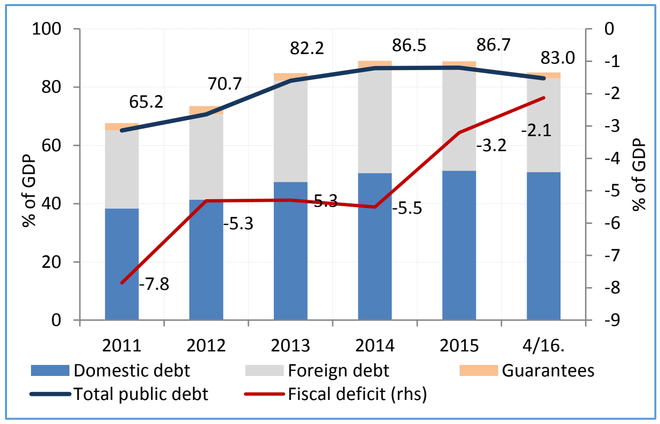
Despite continuing household and corporate deleveraging, there are some early signs of bottoming out in 2016. Compared to end-2015, in the first half of 2016 loans to corporations stagnated; with two-thirds of loans denominated in foreign currency, once corrected for the kuna's appreciation against the euro by 0.7 percent and against the Swiss franc (CHF) by 5 percent, corporate lending has picked up. Household loans, still largely influenced by the conversion and a partial write-off of CHF loans, decreased by 5 percent by June. Deposits grew by 4.5 percent.

Nonperforming loans (NPLs) continued to decline in 2016; dropped from 16.6 percent in December 2015 to 15 percent in June, mainly because of continued sale of NPLs to factoring companies and their write-offs. The largest impact on the decline came from a reduction in corporate NPLs, followed by loans to households. Credit stagnation and NPLs will continue to weigh on the profitability of banks, as will the costs of conversion of CHF-pegged loans to euros. The EC has requested a response to the EC-initiated proceedings against Croatia by warning that its legislation enabling the conversion of loans indexed to the CHF to euros was in violation of EU law—the grounds are that it jeopardizes the principle of free movement of capital, enabling universal conversion of loans regardless of individuals' ability to repay, and the fact that the law is retroactive puts at risk legal security and predictability.

Fiscal consolidation continued in 2016. The general government deficit narrowed to 2.1 percent of GDP by March (on a 12-month basis) because of rising tax revenues (especially corporate tax and excises) and social contributions and lower expenditures supported by temporary financing in effect in Q1 after the general elections. The fiscal position had again improved by July, pushing the general government deficit to around 2 percent of GDP as direct taxes and absorption of EU funds improved. At the end of May, public debt further declined to 83 percent of GDP.

EC decided not to step up the Macroeconomic Imbalance Procedure for Croatia. The decision was based on a positive assessment of Croatia's National Reform Plan (NRP) and Convergence Program, which the EC regarded as an ambitious agenda with measures that are relevant for addressing its macroeconomic imbalances. However, the EC strongly recommended five measures: (1) reducing the general government debt ratio, with a fiscal adjustment of at least 0.6 pp of GDP in 2017, and introducing a property tax and a debt management strategy; (2) penalizing early retirement, accelerating the transition to full retirement age, and consolidating social benefits; (3) reducing fragmentation and harmonizing wage-setting systems across the public administration, reinforcing the monitoring of SOEs, and speeding up the process of divesting state assets; (4) reducing parafiscal charges and administrative burdens on businesses and removing regulatory restrictions on professions; and (5) improving the quality and efficiency of judicial system and the tax treatment of NPLs.

Figure 2. General Government Deficit and Debt, 2011–16, Percent of GDP



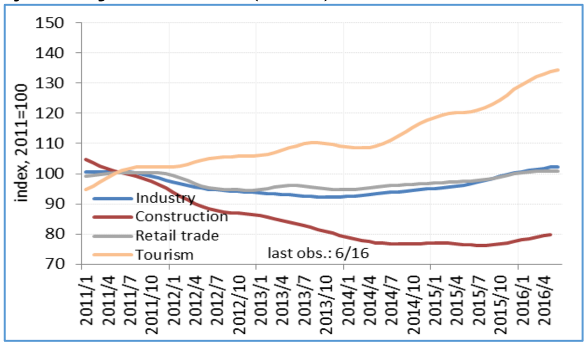
Source: MoF, CBS, WB calculations.

The political crisis caused by the weakness of the governing coalition ended in July with the collapse of the government and dissolution of Parliament. Conflicts between ruling parties ended with the Parliament's vote of no-confidence in the Prime Minister. Early elections took place on September 11 suggesting another coalition government would need to be formed.

Although the government turmoil delayed a Eurobond, Croatia managed to raise funds locally on favorable conditions. The government postponed a bond issue abroad because of the high risk premium, but in June was able to sell locally five-year bonds amounting to HRK6 bn with a yield of 2.85 percent, supported by strong domestic liquidity. This is the lowest yield on Croatian government bonds since the 2001 inaugural bond issue on domestic capital market.

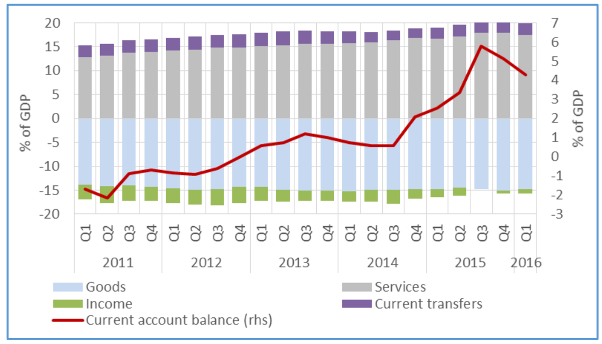
Growth is expected to remain solid in 2016-18, averaging 2.3 percent. Risks are still skewed to the downside. Along with risks related to the fiscal consolidation and the sustainability of public debt, high levels of private sector indebtedness and the possibility of a further rise in the risk premium for emerging markets has arisen as the country plans its refinancing strategy for redeeming three sovereign bonds in 2017. A protracted formation of the new government after September elections may lead to more delays in absorption of EU funds and another year of delays in the structural reforms announced in the NRP. Furthermore, financial volatility following Brexit and monetary tightening in the USA could have negative effects on the borrowing costs of domestic sectors. While with the current pace of consolidation Croatia sees the possibility of exiting the Excessive Deficit Procedure in 2017, its macroeconomic imbalances will require a robust response by the new government.

Figure 3. High-frequency Real Sector Data, Trend-cycle Adjusted Series (Index)



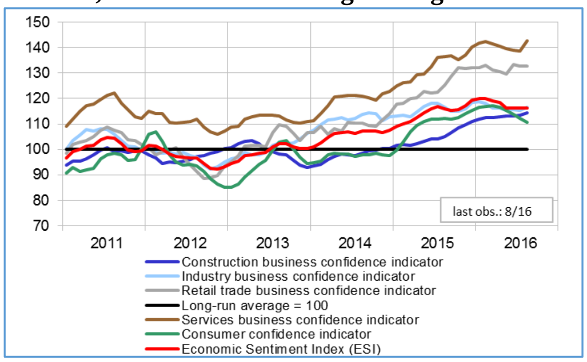
Source: CBS, WB staff calculations.

Figure 4. Current Account Balance, 2011–16, Percent of GDP



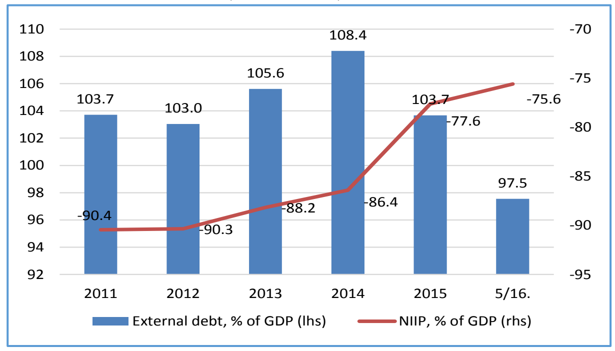
Source: CNB, CBS, WB staff calculations.

Figure 5. Business and Consumer Confidence, 2011–16, Three-month Moving Averages



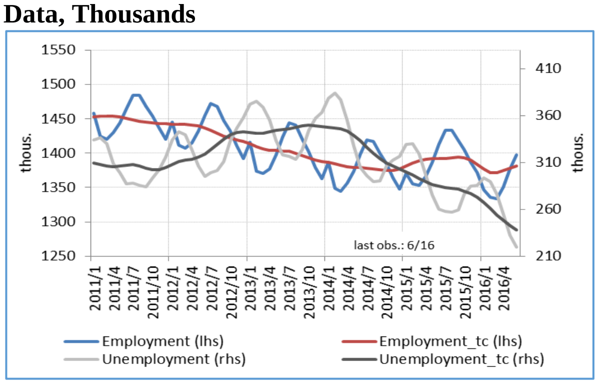
Source: EC, WB staff calculations.

Figure 6. External Debt and Net International Investment Position, 2011–16, Percent of GDP



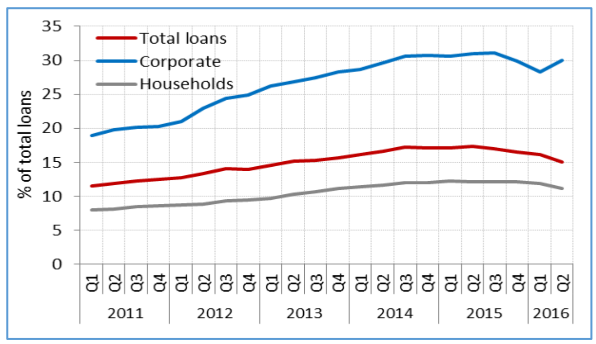
Source: CNB, CBS, WB staff calculations.

Figure 7. Labor Market, 2011–16, Administrative Data, Thousands



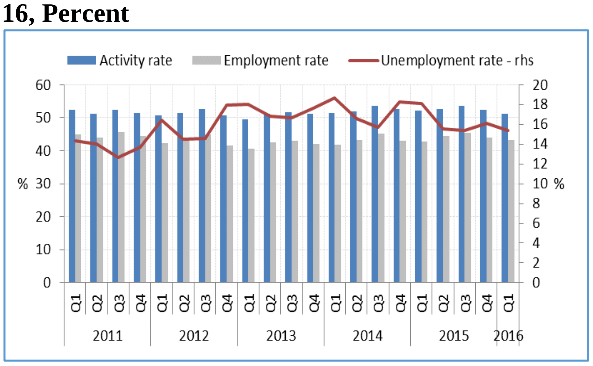
Source: CBS, WB staff calculations.

Figure 8. Nonperforming Loans, 2011–16.,Percent)



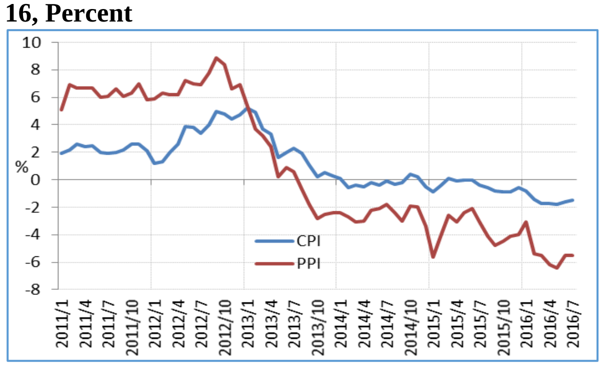
Source: CNB.

Figure 9. Labor Market, Survey-based Data, 2011–16, Percent



Source: CBS.

Figure 10. CPI and PPI, Annual Growth Rates, 2011–16, Percent



Source: CBS.

Croatia

Selected Indicators	Avg. '00-14	2012	2013	2014	2015	2016 E	2017 F
Income and economic growth							
GDP growth (annual %)	1.7	-2.2	-1.1	-0.4	1.6	2.4	2.0
GDP per capita growth (annual %, real)	2.2	-1.9	-0.8	0.0	2.8	2.7	2.3
GDP per capita (US$, nominal)	11129	13236	13575	13481	11629	12012	12473
GDP per capita, PPP (current international $)	17232	21114	21351	21252	21709	22176	22653
Private Consumption growth (annual %)	1.6	-3.0	-1.8	-0.7	1.2	2.0	1.4
Gross Investment (% of nominal GDP)	23.1	19.6	19.8	19.1	19.1	19.5	20.2
Gross Investment - Public (% of nominal GDP)[1]	5.0	3.5	3.7	3.7	2.9	3.2	3.1
Money and Prices							
Inflation, consumer prices (annual %, end of period)[2]	2.6	4.7	0.3	-0.6	-0.5	1.0	1.5
Inflation, consumer prices (annual %, period average)[2]	2.7	3.4	2.2	-0.2	-0.5	0.9	1.5
M2 (% of GDP)	64.6	74.6	77.7	80.7	83.6	84.2	84.8
Domestic Credit to the Private Sector (% of GDP)[1]	59.8	71.5	71.0	69.9	66.6	66.0	65.8
10 year interest rate (annual average)[2]	..	..	..	..	..	..	..
Nominal Exchange Rate (local currency per USD)	6.2	5.9	5.7	5.7	6.9	6.8	6.8
Real Exchange Rate Index (2010=100)	103.1	105.3	104.2	105.4	109.9	110.1	110.2
Fiscal							
Revenue (% of GDP)	42.1	41.7	42.5	42.6	43.7	44.0	43.7
Expenditure (% of GDP)	46.6	47.0	47.8	48.1	46.9	46.7	45.8
Interest Payments (% of GDP)	2.3	3.4	3.5	3.5	3.6	3.6	3.6
Non-Interest Expenditure (% of GDP)	44.3	43.6	44.3	44.6	43.3	43.1	42.2
Overall Fiscal Balance (% of GDP)	-4.5	-5.3	-5.3	-5.5	-3.2	-2.7	-2.1
Primary Fiscal Balance (% of GDP)	-2.2	-1.9	-1.8	-2.0	0.4	0.9	1.4
General Government Debt (% of GDP)	50.4	70.7	82.2	86.5	86.7	86.0	84.9
External Public Debt (% of GDP)[1]	24.2	29.3	34.7	36.0	35.4	36.6	36.7
External Accounts							
Export growth, f.o.b (nominal US$, annual %)	10.0	-7.8	6.4	6.7	-8.2	5.8	4.7
Import growth, c.i.f (nominal US$, annual %)	8.3	-8.8	6.1	3.0	-9.5	5.9	5.1
Merchandise exports (% of GDP)	17.1	19.7	20.5	22.7	24.4	24.6	24.9
Merchandise imports (% of GDP)	35.5	34.0	35.6	37.5	39.5	40.1	40.5
Services, net (% of GDP)	14.3	14.6	15.5	16.9	18.0	18.4	18.4
Current account balance (current US$ millions)	-1705	-167	566	1123	2603	1595	1568
Current account balance (% of GDP)	-3.6	-0.3	1.0	2.0	5.3	3.2	3.0
Foreign Direct Investment, net inflows (% of GDP)	3.5	2.7	1.9	1.9	0.4	2.7	3.2
External debt, total (% of GDP)[1]	81.5	103.0	105.6	108.4	103.7	97.1	89.1
Multilateral debt (% of total external debt)[1]	6.3	8.3	9.0	9.8	11.2	12.6	14.3
Debt service ratio (% of exports goods and non-factor services)[1]	42.4	63.6	51.4	53.0	51.4	46.7	49.1
Population, Employment and Poverty							
Population, total (millions)	4.4	4.3	4.3	4.2	4.2	4.2	4.2
Population Growth (annual %)	-0.5	-0.3	-0.3	-0.4	-1.1	-0.3	-0.3
Unemployment Rate[1]	13.5	15.9	17.3	17.3	16.3	16.0	15.6
Poverty headcount ratio at national poverty line (% of population)[1]	20.2	20.4	19.5	19.4	20.4	..	..
Poverty headcount ratio at US$5 a day (PPP) (% of population)[1]	8.5	9.4	9.8	9.8	9.0	8.7	8.4
Inequality - Gini Coefficient[1]	31.1	30.9	30.9	30.2	30.9	..	..
Life Expectancy[1]	75.7	76.9	77.1	77.6	..	..	..
Other							
GDP (current LCU, millions)	285601	330456	329571	328431	334219	343537	353231
GDP (current US$, millions)	48713	56486	57770	57137	48732	50173	51928
GDP per capita LCU (real)	71692	74976	74385	74419	76504	78598	80434
Doing Business Rank[3]	39	..	..	39	40	..	..
Human Development Index Ranking[4]	46	47	47	47	..	..	..

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.

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