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Economic Crisis in Croatia

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Abstract: *Croatia is becoming the 28th member of the European Union on July 1st, 2013. Croatia has gone a long way from a socialist republic to an independent country recognized as one of the economic tigers of the Western Balkans in the first decade of the 21st century.*

Croatia has been hit by the global crisis, which turned out to be a huge external shock for the region of the Western Balkans. Although it does not enter the economy through the direct channels, as local banks have not been engaged in toxic assets trade, but indirect channels, like the decrease of FDI, which deepens foreign trade deficits, slow credit growth or decrease of remittance which lead to economic disturbances during the last phase of the European integration process. Small economies, like Croatia, are exposed much more to the effects of any disturbances on the international scene. They are dependent on foreign trade and the inflow of FDI, while their demand and inflation rate are affected by the pace of changes in big economies.

The article addresses the problem of economic development in the country which needs to deal with a problem of the economic crisis infection and the EU integration process. The article studies the economic situation in Croatia which is the consequence of a recovery plan undertaken by the Croatian government.

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Introduction

In the last decade the Western Balkans experienced the economic growth, measured by the increase of GDP by 5% y/y. No change in this scope is expected in the future. For small economies, like the Western Balkan countries, any slump – noticed in the 4th quarter of 2008 – can be treated as a detriment stroke. Small economies are exposed to international disturbances, especially when they stay in relatively close trade relations with the EU. Although the region as a whole avoided deep recession, some countries could not avoid it, especially when the Austrian or Greek parent-companies of local banks decided to cut the credit supply. It proves that small countries are in danger of being affected by the economic crisis which was a result of global financial crisis.

Content and Methods

The main objective of the article is to provide the outlook on the Croatian economic situation which deals both with economic crisis and process of European integration. Moreover, the survey of a recovery plan was carried out to present the situation in the country just before joining the EU.

The first part of the article reviews the literature on the subject of the crisis influence on small economies. The second part considers the economic situation in Croatia. The various indices were used to describe the economic situation: value of FDI, the value and rate of change of foreign trade and credit growth. It is followed by the detailed analysis of the recovery plan. The final part is focused on the analysis of the effects of the undertaken recovery actions and its influence on general government budget.

The following research methods were used to gather and to analyze the qualitative and quantitative data: document review, literature review and international study. Various documents were collected: reports, financial statements covering the performance and structure of the studied economies. The theoretical part of the article consists of literature and acts of law review which are publicly available. The empirical part of the article is based on comparative analysis and studies of various macroeconomic indices till 2011. Data are provided by Eurostat and the Croatian Central Bank.

Influence of an Economic Crisis on Small Economies

The literature on small economies is abundant, but it does not define precisely a small economy. S.Kuznets in Economic Growth of Small Nations (1960) stipulates on the upper limit of population in order to classify this kind of economies. The limit was set up for 10 million of citizens. But there are also other features characteristic of small economies (World Bank 2000):

- limited institutional efficiency – sovereignty leads to fixed costs connected with public services, like educational system, health care system, justice. Due to a relatively small number of citizens and small area of a country, those costs are comparatively high.
- restrictive diversification – due to a limited access to raw materials, as well as small domestic markets, many small economies are not able to diversify their trade partners or their production. This leads to limitations in private sector efficiency, which can cause additional risk of operations in a changeable environment.
- openness – small economies are particularly dependent on foreign trade or inflow of FDI in order to increase the access to raw materials. On one hand, it improves their international competitiveness, but on the other hand – it may create additional risk of macroeconomic crisis infection.
- access to foreign capital – access to global capital markets is particularly important in case of small economies. Because of a relatively high risk of operations, not only the cost of fund raising is high, but also access to foreign capital market is more difficult.

According to Favaro (2009), the crisis to a bigger extent affects small economies which deal with higher current account deficits and receive higher income per capita. Hitherto economic growth was financed with foreign direct investment. The recession was caused by a sudden reduction of FDI inflow, as well as by problems on internal financial markets. The increase of general government deficit is really dangerous for the countries with high public debt, measured by its share in GDP.

The first studies on the influence of big, developed countries on macroeconomic situation in small countries were carried out by Dornbusch (1985). He analyzed impact of big economies on global prices and consequently on business cycles in developing countries. Following Dornbusch, many studies were conducted on external shocks affecting small economies. Calvo, Leiderman and Reinhart (1993) study the influence of such shocks on volatility of foreign exchange rates in Latin America. Reinhart and Reinhart (2001), as well as Frankel and Roubini (2001), discovered the negative impact of interest rates in USD on the level of GDP in developing countries. Neumeyer with Perri (2005), and Uribe with Yue (2006), investigated how foreign interest rates affect the business cycles in developing countries. The influence of key macroeconomic factors in the USA on the activity level in Canada was studied by Cushman and Zha (1997), in Mexico – by Del Negro and Obiols-Homs (2001). The findings of these and other studies (Korhonen 2003; Fidrmuc, Korhonen 2003; Maćkowiak 2006; Horváth, Rusnák 2009) confirm the influence of economic situation in big economies on small economies (Krznar, Kunovac 2010).

Political Background

After the World War II, the Socialist Federal Republic of Yugoslavia (the SFRY) consisted of six provinces: the Socialist Republic of Bosnia and Herzegovina, the Socialist Republic of Croatia, the Socialist Republic of Macedonia, the Socialist Republic of Montenegro, the Socialist Republic of Serbia and the Socialist Republic of Slovenia. Till 1980 the country was governed by Marshal Josip Broz Tito. Thanks to his strong political leadership, and the estrangement from the USSR in 1948 the SFRY could expect support via the Marshall Plan from the West. Tito, with a hard line on government, ruled in a dictatorial way. The SFRY was constructed by the communists as a formally federal socialist country but stayed outside the Soviet bloc. The country had always been a home to a very diverse population, both in terms of national and religious affiliations.

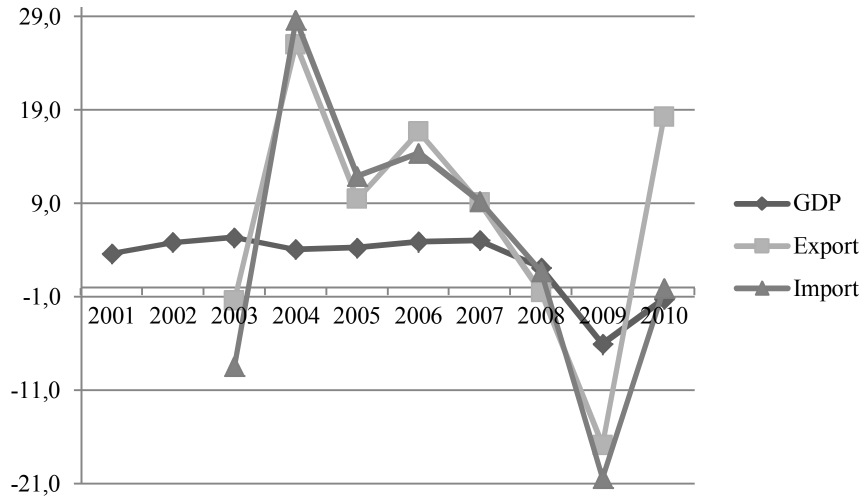
In the 80's, in consequence of an inter-ethnic conflict, which developed into an open war, the former SFRY was dissolved into a group of states which had to build their institutional infrastructure almost from scratch. Croatia was the first republic which announced its independence in June 1991. It was followed by other former republics of the SFRY: Slovenia and Macedonia (in 1991), Bosnia and Herzegovina (in 1992), Montenegro (in 2006), Kosovo (in 2008).

Changes of the Key Macroeconomic Indicators

For the region of the Western Balkan, the financial crisis turned out to be a huge external shock. Although the local banks did not trade with toxic assets, which was a direct channel of the crisis infection, the slump reached the region by indirect channels. The first sign was a decrease of foreign trade value, sudden decline of credit supply, rapid drop of FDI inflow and decrease of remittance, which were responsible for changes in goods, capital and labor markets (Bartlett, Monastiriotis 2010).

Almost throughout the first decade of 21st century the Croatian economy was growing at a relatively high level, between 3,66% p.a. in 2001/2000 and 5,13% p.a in 2003/2002 & 6,06% p.a. in 2007/2006. During this period, all indices showed favorable tendencies confirming significant progress in economic transformation. One year after the crisis started, Croatia experienced a serious drop in GDP, by almost 6% between 2008 and 2010, which is presented in Figure 1. This decline was caused by a number of economic changes.

Figure 1. Annual changes of GDP, export and import (in %)

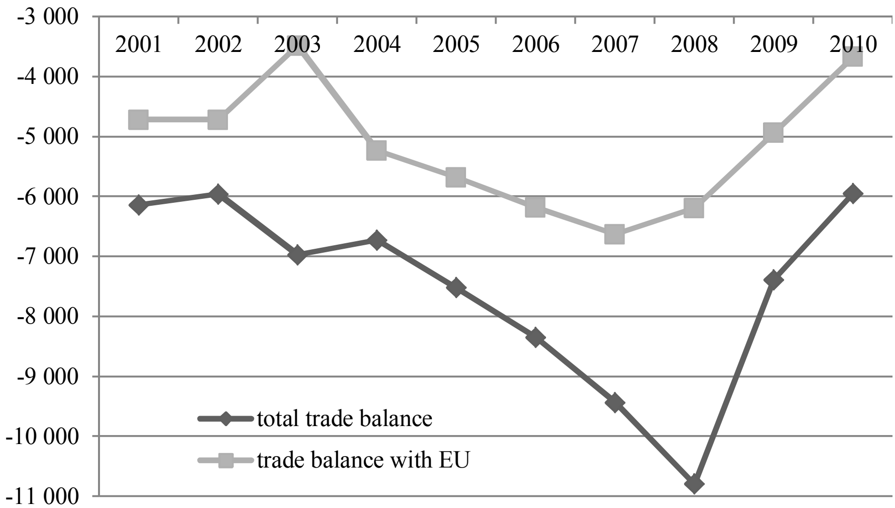


Source: own calculations, based on Eurostat.

In a small economy, production factors are concentrated in a few economic sectors. Therefore, foreign trade is essential for its existence. Generally speaking, the main trade partners are limited to a group of countries, mostly big economies (Kuznets 1960). From the economic perspective, this should not affect the economy negatively, if the surrounding international environment develops in a stable way.

A sudden drop in the global trade in the second half of 2008 hit all European countries, especially those which depend on the foreign trade with members of the EU, including Croatia. A significant decrease of export and import was noticed in 2009. In 2009, comparing to 2008, the Croatian export fell by about 15-16% and the import – by almost 20%. In consequence of the declining export, the trade deficit increased. Since 2000, Croatia has experienced a deficit in foreign trade, which increased from 5,25 billion euro in 2000, to more than 10 billion euro in 2008, when it reached its peak value. A year later, the net export decreased by more than 2,3 billion euro. Croatia is the country whose trade relations with the EU are particularly tight. This leads to a relatively high share of the EU in Croatian foreign trade, and in consequence in Croatian trade deficit. Despite the declining share of the EU trade deficit in total, the Croatian trade deficit, still the EU share amounts to over half of the total Croatian trade deficit (Figure 2). It proves strong relations with the EU countries. The decreasing tendency is caused by the rising importance of mutual trade within CEFTA 2006.

Figure 2. Value of import and export (million of euro)



Source: own calculations, based on Eurostat.

Changes of Credit Supply

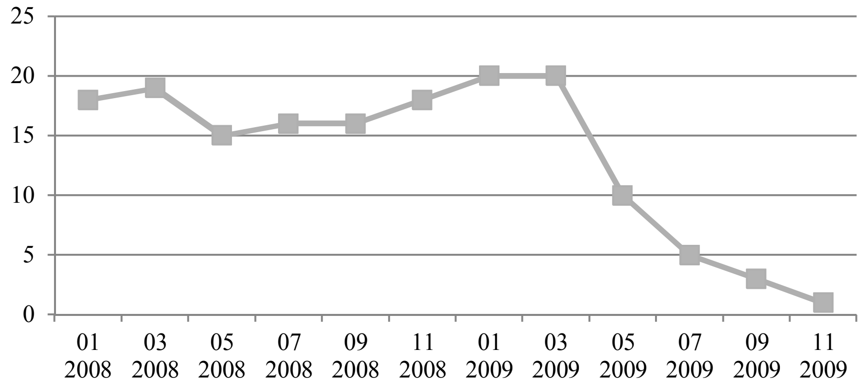
Countries which experienced a relatively high current deficit are threatened by limited access to credit. Members of the EU are, on one hand, the main trade partners and the main investors in the Balkan banking sector, but on the other hand, they experience serious economic problems. Parent companies of banks investing in the Balkan banking sector, first support their own economies. This leads to a decline in credit supply in their branches and daughter-companies, including those in the Balkan market (Charlemagne 2009).

Retention of credit supply plays a key role in the infection by economic crisis in the Balkan region. This is essential for the economies whose banking sectors belong in majority to foreign investors, and therefore they are dependent on foreign capital. During the last decade, the foreign investors entered the Balkan market through mergers and acquisitions, expecting to receive exceptionally high returns. They offered various loans and credits to households and enterprises which by this time had to deal with underdeveloped financial market. It is believed that, in many cases, the retention of credit supply was much more important as a reason detrimental to the growth of local economies than the decline of foreign trade since export accounts for only a few percent of GDP (Petrovic 2010).

Croatia faced this problem in a particular way. This negative influence would have been even more serious but for the actions undertaken by international institutions, cooperating in order to guarantee liquidity to banks in the Balkan countries within Vienna Agreement.[1] Till the end of the first quarter of 2009, the credit supply in Croatia was increasing (Figure 3), mainly thanks to the Croatian National Bank which lowered the reserve requirement rate from 17% to 14% in December 2008. The Croatian banking sector includes 17 foreign banks out of 33 operating there. The foreign investors, mainly originating from EU, hold over 90% of total banking assets in Croatia. And since the beginning of the second quarter 2009, the credit supply has been dramatically falling down. The reason for this fact should be viewed in connection with the rise of lending interest rates which did not stop even by a further cut of required reserves rate to 13% in February 2009.

[1] Vienna Agreement – meeting of supervising institutions representatives of banking market in the EU, in host countries and banks investing in developing countries (EFG, Erste, Intesa, KBC, Piraeus Bank, Raiffeisen International, Societe Generale, Unicredit), as well as representatives of international institutions, including IMF, European Commission, World Bank and EBRD.

Figure 3. Evolution of credit growth (in % y/y)



Source: *South East Europe after*… (2010).

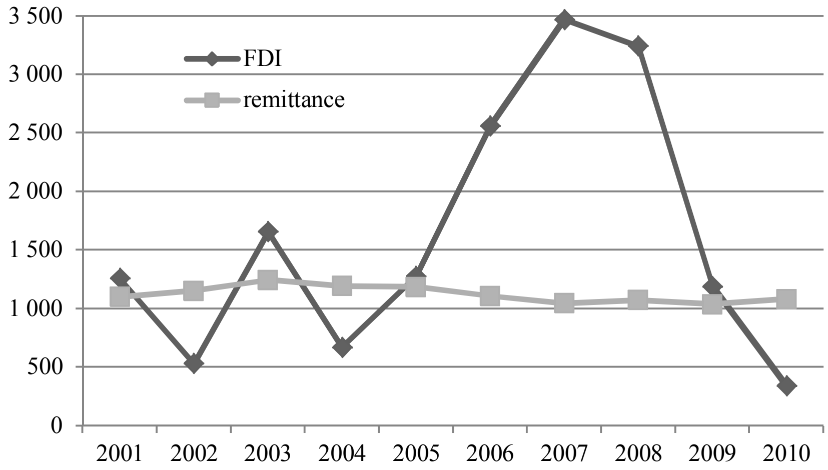
It must be emphasized that the nonperforming loans were increasing particularly fast, especially the loans taken in foreign currencies (Eastern European banks: The ties that band 2009). This is another proof of the local banking market weakness, which depends on the liquidity provided by parent companies.

Foreign Direct Investments (FDI) and Remittance

Thanks to the privatization process in post-socialist countries, foreign investors treated these countries as a destination for their investments, not only in the banking sectors, but also in telecommunication and energy sectors. Croatia was dependent on the FDI inflow much more than any other neighbor from the region (Ott 2010), and therefore it was hit much more by smaller FDI inflow. On the other hand, the region of the Western Balkan was not particularly successful in receiving FDI and, therefore, this source did not play a key role in infection by the economic crisis.

Figure 4 presents a serious drop in FDI inflow between 2007-2008. In 2009, the value of FDI was 3 times smaller than in 2007, and it was smaller by 70% in comparison to the previous years.

Figure 4. FDI and remittance (million of euro)



Source: own calculations, based on Eurostat.

Some countries were not only hit by the drop in credit offers or the value of FDI inflow, but they have became victims of problems in the European labor markets. In some cases, there was a serious decline of remittance because foreign employees on European markets were the first to lose their jobs during economic turbulences. In case of Croatia, the remittance accounts for about 3% of GDP (The Western Balkans in Transition 2009). The drop has been significant since 2003 (Figure 4). It has decreased by almost 16%. Since the crisis, it has been staying at the same level around of 1,05 billion euro yearly, amounting to at least twice the value of FDI inflow.

Recovering From the Crisis

Just before the crisis, the Croatian government managed to decrease the budget expenditure in order to balance its budget income. In 2008, the budget deficit reached the level of 1% of GDP. But because of the economic crisis, the forecasts for 2009 had to change. In the middle of 2009 the new plan of general government deficit was assumed for 1,6% GDP, which should have been followed by further savings (IMF 2009). The economic growth which declined by 6% y/y showed that even new plans were impossible to achieve. On one hand, the income was underestimated, on the other hand cost of financing the deficit became higher and higher. It made government search for new fund raising sources (Cocozza et. al 2011). The Croatian government took a number of steps in order to consolidate public finance sector, and simultaneously to decrease expenditure in relation to GDP. The saved capital ought to be used for financing the recovery plan. All tax reductions were abolished, apart from tools supporting research and development. Additionally, in 2009 a new type of tax on wages, pensions and other incomes, called the crisis tax, was introduced for one year (Act on Special Tax on Salaries, Pensions and Other Income (94/09 and 56/10). VAT was increased from 22% to 23%.

In order to decrease the general government budget expenses, it was planned to cut employment in administration by 5%, and its remuneration by 10%. Moreover, a number of measures were introduced to improve the effectiveness of services offered by this sector.

In reference to ownership policy, the government privatized several state-owned enterprises, e.g. Croatian Electric Power, Croatian Insurance, Croatian Railways. The privatization process helped decrease the general government deficit. All these steps led to keeping the deficit at the level of 4% of GDP in 2011, while in 2010 it was 4,7% of GDP. In 2009, the deficit represented 3,3% of GDP.

The government investment policy focuses on energy sector, particularly on renewable energy sources, environment protection, education and health care systems and infrastructure. The projects undertaken in these fields are financed from national public and private resources and foreign funds, including pre-accession ones. The government offers financial aid for the household mortgages taken for purchase of the first real estate or its renovation. This solution should support the construction sector, which suffers from a decline of purchase numbers in real estate market.

In the field of small and medium enterprises, different incentives have been undertaken in order to increase their number. Therefore, the government has diminished most of parafiscal obligations for start-ups, including decrease of the level of obligatory fees in Croatian Economic Association and other administrative expenses.

The Croatian government has undertaken actions to support the Croatian Bank of Reconstruction and Development (HBOR). Although in 2009 the aid for the bank was smaller than a year before, the government signed letters of intent with international institutions (EBRD, World Bank) which agreed to support HBOR with preference credits. Within the steps taken in other sectors, the Tourism Ministry was obliged to present a plan of actions and incentive in services, including marketing and advertisement events on international and national markets.

The government is also interested in promotion of technology transfers and improvement of economy competitiveness to attract foreign investors. Therefore, they lifted the obstacles in this scope, e.g. time allowed to issue a permission for investment was shortened to 45 days, and in case of investment whose value exceeds 10 million euro, the time is reduced to 10 days.

Although unemployment rate in Croatia is relatively low comparing to other countries in the region, the government still tries to improve the flexibility in the labor market. The expenses on labor policy account for 0,4% GDP, and the value of active tools for supporting employment is not higher than 0,1% GDP.[2] Unemployed people are encouraged to increase their qualifications, the procedures concerning redundancy are simplified, subsidies and financial aid is offered to enterprises which implement shorter time of shifts. Moreover, the volume of dole payment is based on minimum salary and not on average salary (Social Impact of the Crisis and Building Resilience, 2010). In 2009, a new program on shortening the working shift was introduced. The government restricted the financial aid aimed at supporting employment. Instead, a new *Economic Recovery Programme* implemented a set of new tools, including trainings for young unemployed, supporting operation of *Croatian Employment Service* in scope of information procedures and consultancy. Tightening the cooperation between *Centers for Social Welfare and Vocational Education and Training Agency* supported the improvement of quality of their services (Plan provedbenih aktivnosti Programa gospodarskogo oporavka, 2011).

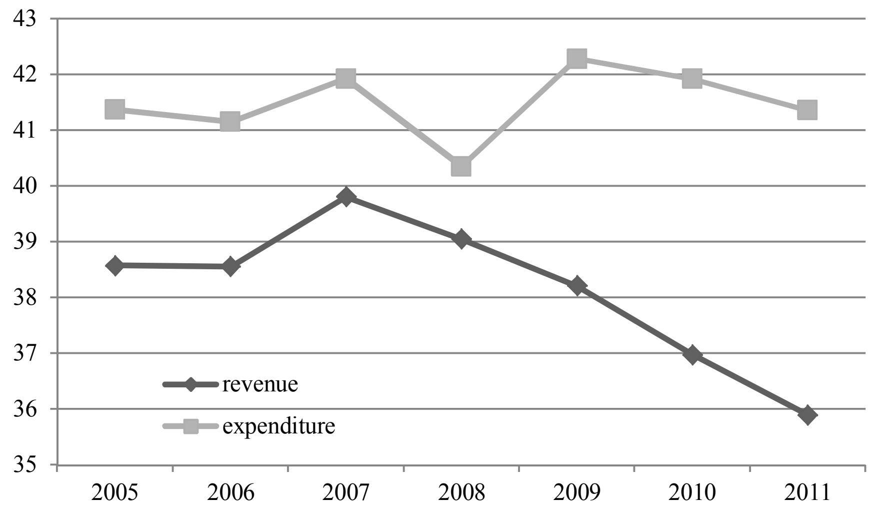
The total welfare expenditure in Croatia accounts for 3,6% GDP and it is almost twice as high comparing to other countries in the region. Despite this high financial commitment, only 52% of the poorest population in Croatia can expect any financial aid and support. The system of social aid in Croatia is very expensive, complicated and ineffective, as numerous institutions engaged are quite lost in various programs and projects they run. Moreover, as there are no harmonized criteria for granting the help and there is no common objective, the result is unequal treatment of the beneficiaries of the welfare system. The situation may improve thanks to the implementation of *Economic Recovery Programme,* but the effects are not yet visible.

[2] In the EU expenses financing active tools of employment policy account for at least one third of expenses for labor market.

The Effects of Recovery Policy in Croatia

In 2009, the countries in the region experienced the increase of general government deficit, measured with % of GDP. In Croatia, it was assumed at the level of 4,1%, which was one of the lowest in the region. (Pere, Hashorva 2011). As a consequence of the recovery policy in Croatia, between 2005 and 2011 the budget revenue value increased by 20%, which was one of the lowest in the region. But in relation to GDP, it dropped by 3 p.p. to 35% GDP. The policy of government expenditure resulted in its value increase by 28% in the studied period. But relating to GDP, it remained on the average 41% GDP, with a slight decrease in 2008, which is presented in Figure 5.

Figure 5. Total government revenues and expenditure as % GDP

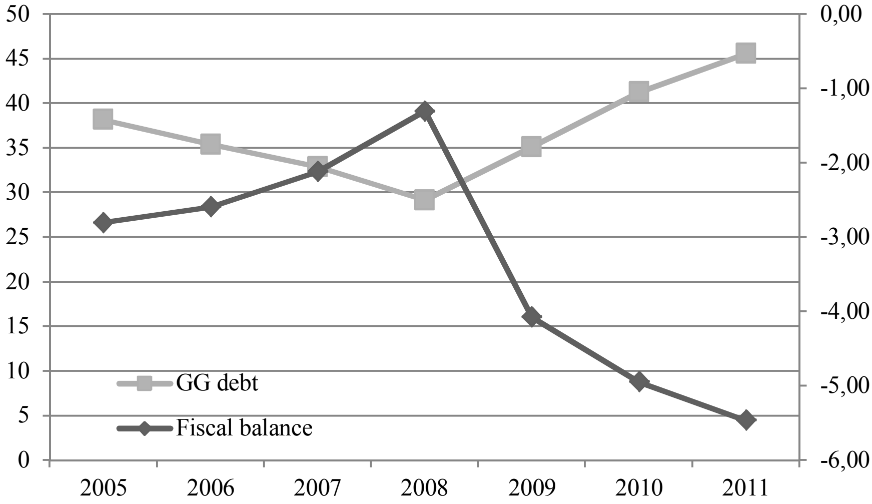


Source: own calculations, based on International Monetary Fund, World Economic Outlook Database, April 2012.

Changes in the values of total government revenues and expenditure influenced the value of fiscal balance and height of its deficit. Until 2008, Croatia managed to decrease its deficit, reaching nearly 1% GDP. In the following years this favorable situation could not be achieved, while the deficit was getting bigger and bigger. In 2011, it accounted for almost 6%

GDP. It was followed by the changes in the debt of the country, which is presented on Figure 6.

Figure 6. Fiscal balance and general government debt as % GDP



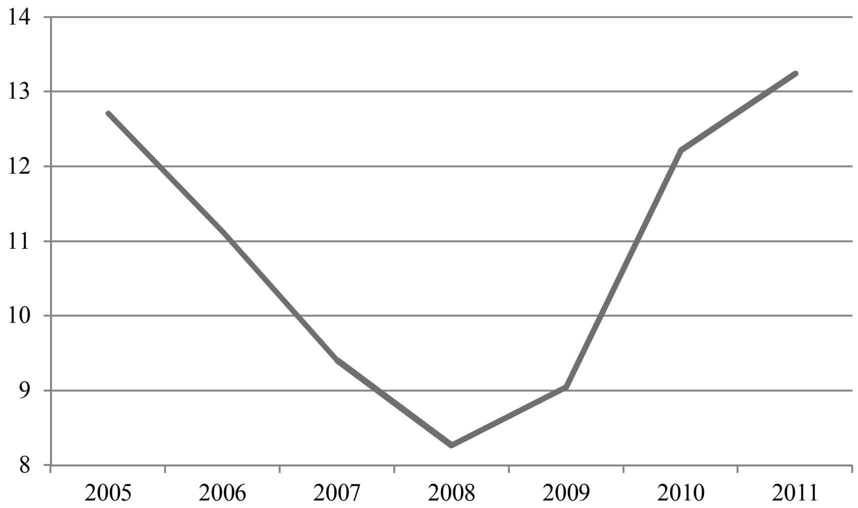
General Government debt (GG debt) is presented on the left hand ax.
Fiscal balance is presented on the right hand ax.

Source: own calculations, based on International Monetary Fund, World Economic Outlook Database, April 2012.

Figure 6 presents simultaneous increase of fiscal deficit up to almost – 5,5% GDP, which was the consequence of hoist of expenditure, and rise of debt between 2008 and 2011. Considering the average debt in the Western Balkans, its countries are not heavily indebted. According to IMF data, the total government debt in Croatia decreased by 9 p.p. from 38% GDP to 29% GDP in 2008. After 2008, the public debt increased significantly by 16,5 p.p. to 45,5% GDP, which was one of the highest rises in the region.

Unemployment data show that unemployment was already a serious problem before the crisis. The unemployment rate was falling in Croatia from level of 13% in 2005 to 8,3% in 2008. After the infection with the crisis, the problem of employment began to rise. By 2011 the rate returned to the level from 2005, which is shown in Figure 7.

Figure 7. Unemployment rate (in %)



Source: author's calculations based on International Monetary Fund, World Economic Outlook Database, April 2012.

Although the economic situation in the Western Balkans has improved: inflation rate decreased to the acceptable level, exchange rates of local currency stabilized, the unemployment is still one of the key problems.

Conclusions

The economy of Croatia, like in other countries of the Balkan Region, can be described as strongly dependent on the European Union, its major trade partner. The growth of the economy is related to the inflow of foreign trade and FDI, focused on the sector of services, particularly on banking, telecommunications and real estate markets. The share of foreign capital banks in total assets of the sector ranges from 75.3% to 95.0%. Therefore, this can be named as one of the main causes of the economic crisis. The Croatian export fell, as did the credit supply. The reduction of interest rates by central bank did not improve the situation. This proves that economic development model based on the speed of FDI inflow, credit supply, export of labor resources is vulnerable to economic disturbances. The society has to deal with the results of the global economic crisis, like increase of unemployment rate, rise of goods prices or restricted access to credits and loans.

The Croatian government has undertaken "a standard basket of actions". They included overtaking the liabilities, decrease of the labor cost, subsidizing credits financing the investment projects. Protecting employees, the government has not always provided the equal conditions for market competition, by privileging groups of enterprises or selected sectors of economy.

The Croatian recovery plan did not bring promised results: the unemployment rate returned to the level from 2005, the government deficit was much higher than planned. International Monetary Fund presents optimistic forecasts for the GDP in the coming years. However, the crisis pointed out the fields which need to be improved and the reforms which need to be applied. Regional cooperation and market reforms are of particular importance. It is also required for Croatia to improve the export competitiveness of its manufacturing industry and to do a switchover of the existing model of economic development to knowledge economy. Internal demand is perceived as a key factor for the near future to contribute to the needed economic growth.

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