

### Box 3

#### **CROATIA JOINS THE EUROPEAN UNION**

Croatia became the 28th Member State of the European Union on 1 July 2013. From an economic perspective, the accession of Croatia to the EU has the potential to contribute positively to the country's economic growth and welfare, and to that of the Union as a whole, by, for example, creating new trade and investment opportunities. In particular, more inward foreign direct investment (FDI) in the tradable sector would be a key ingredient in the expansion of Croatia's investment activities and export base through a better integration into the pan-European production chain. A full and efficient absorption of EU structural and cohesion funds would also be helpful, to the extent that these transfers are invested to enhance the production capacity of the country, rather than financing public and private consumption. Compliance with the reformed

economic, fiscal and financial governance of the EU would also provide a key anchor for the pursuit of sustainable growth in a stable macroeconomic and financial environment. To fully exploit these potential benefits, however, a number of conditions would need to be fulfilled, some of which are mentioned at the end of this box.

Croatia's GDP accounts for only 0.34% of EU28 GDP and, with 4.3 million inhabitants, its population for 0.84% of the EU28 population. Therefore, the statistical macroeconomic features of the EU economy as a whole have not changed significantly as a result of the enlargement. In 2012, Croatia's GDP per capita in purchasing power parity (PPP) terms stood at 61% of the EU27 average, the third lowest when ranked alongside EU countries. The country made progress in income convergence towards the EU average until 2008, but this trend reversed thereafter owing to the prolonged economic recession.

The output of Croatia has expanded less than that of most regional peers over the past decade. This holds true both for periods before and after the crisis. In 2013, the Croatian economy is projected to experience negative growth for the fifth consecutive year, although the pace of economic contraction has eased somewhat. Real GDP has cumulatively contracted by around 11 percentage points since the outbreak of the crisis in 2008. In the period 2004-2008, annual real GDP growth averaged at 4.1% and was largely driven by an unsustainable expansion of domestic demand, spurred by rapid debt accumulation. The transition towards a more sustainable growth model has yet to be accomplished, despite some progress made in the implementation of reforms.

Croatia's economic structure is broadly similar to that prevailing in the other EU Member States. It is characterised by the high share of the services sector, which accounts for 70% of gross value added. Manufacturing represents around 15% of the economy. The relative weight of the agricultural sector, at 5%, is above the EU average (1.7%). The single most important industry in Croatia is tourism, with a GDP share of about 20%. Croatia is an open economy and the EU is its key trading partner, accounting for 61% of total trade. However, Croatia's export performance has been relatively subdued over the last decade as its export market shares in terms of world exports to both the EU and the rest of the world declined.

In contrast to several other EU Member States in central and eastern Europe, Croatia has a history of relatively low and stable inflation, averaging 2.8% over the last decade. After HICP inflation temporarily picked up to 3.4% in 2012 – primarily owing to hikes in VAT and rises in administered, food and energy prices – it declined to 1.8% in May 2013, reflecting the fading of such effects. The price level of final consumption by households (including indirect taxes) stood at 71% of the EU27 average in 2012 and was the third highest among the non-euro area EU countries in central and eastern Europe.

Unemployment is high and the participation rate is low. Reflecting the prolonged recession, the unemployment rate more than doubled after 2008, reaching 18.3% in the first quarter of 2013. This is the third highest rate of unemployment in the EU. The participation rate, at 60.5%, is the lowest in the EU, reflecting factors such as rigid labour market regulations and generous social benefits.

The current account has improved considerably since the trough reached in 2008 (-8.9% of GDP), and it was in balance in 2012. The process of external adjustment was initially driven by an improvement in the balance of trade in goods. More recently, the rising surplus stemming from trade in services – mostly tourism, but also other business services – has been the dominating

## Key economic features of Croatia and the enlarged EU

		2012	
		EU28	Croatia
<b>Population and economic activity</b>			
Total population <sup>1)</sup>	(millions)	508.5	4.3
GDP	(EUR billions)	12,945.4	43.9
GDP per capita (PPP)	(EU28=100)	100	61
GDP (share of world GDP) <sup>2)</sup>	(percentages)	19.5	0.09
<b>Prices and costs</b>			
HICP inflation	(average annual percentage change)	2.6	3.4
Gross wages and salaries	(average annual percentage change)	2.3	0.5
Unit labour costs	(average annual percentage change)	1.8	1.2
<b>Sectors of production<sup>3)</sup></b>			
Agriculture, fishing, forestry	(percentage of total)	1.7	4.5
Industry (including construction)	(percentage of total)	24.6	25.1
Services (including non-market services)	(percentage of total)	73.7	70.4
<b>External trade<sup>4)</sup></b>			
Exports of goods and services	(percentage of GDP)	44.8	43.4
Imports of goods and services	(percentage of GDP)	42.8	42.7
Current account balance	(percentage of GDP)	0.9	-0.1
<b>Labour market</b>			
Labour force participation rate	(percentage of working age population)	71.7	60.5
Unemployment rate	(percentage of labour force)	10.5	15.9
Employment rate	(percentage of working age population)	63.2	49.5
<b>General government<sup>5)</sup></b>			
Balance	(percentage of GDP)	-4.0	-3.8
Revenue	(percentage of GDP)	45.4	36.8
Expenditure	(percentage of GDP)	49.4	40.6
Gross debt outstanding	(percentage of GDP)	86.8	53.7
<b>Monetary and financial indicators</b>			
Credit to the private sector	(percentage of GDP)	140.5	80.6
Stock market capitalisation	(percentage of GDP)	60.5	38.7

Sources: Eurostat, European Commission, ECB, IMF, Zagreb Stock Exchange and ECB calculations.

Notes: Comparisons between Croatia and the EU28 are based on a conversion of national data into EUR using the average nominal HRK/EUR exchange rate prevailing in the corresponding periods, unless the data were already available in EUR.

1) Annual average.

2) GDP shares based on purchasing power parity (PPP) valuation of country GDPs.

3) Based on real gross value added.

4) National accounts data. EU data are compiled on the basis of transactions with residents of countries outside the EU (i.e. excluding intra-EU flows) and data for Croatia reflect transactions of Croatia with the rest of the world (i.e. including intra-EU flows).

5) General government data have not been formally validated by Eurostat.

factor. Croatia's external position remains vulnerable, however, with a large stock of net external liabilities, standing at 88.5% of GDP in 2012.

Croatia's government debt is estimated to have nearly doubled since 2008, and to have stood at 53.7% of GDP in 2012. The fiscal deficit is estimated to have decreased to 3.8% of GDP in 2012, from 5.7% in 2011. The implementation of a clear and sustainable fiscal consolidation strategy is required, including reforms of the pension and health care systems.

The financial system of Croatia is bank-based. The banking industry is dominated by foreign ownership, which accounts for over 90% of total banking sector assets, mostly from the rest of the EU. Strong credit growth, mainly in credit denominated in or indexed to foreign currency, was a salient feature of banking developments in the run-up to the global crisis. The subsequent economic downturn and the process of balance sheet deleveraging have led

to a marked fall in credit. Despite the strong adjustment on the flow side, however, the ratio of private sector credit to GDP still stood at close to 81% in 2012. In this context, the rising non-performing loans (14% of total loans at the end of 2012) are the main source of concern with regard to financial stability.

Looking ahead, Croatia needs to implement a number of important measures and reforms to fully reap the benefits of EU accession. By attracting capital and growth-enhancing investment, improving competitiveness, strengthening the absorption of EU funds, and pursuing counter-cyclical macroeconomic policies and sound micro- and macro-prudential policies, Croatia has the potential to resume the catching-up process and resume income convergence. Above all, further structural reforms are needed, including those aimed at improving the efficiency of the public sector, raising labour force participation, increasing flexibility in the labour market, improving the institutional and business environment, and combating the informal economy. It is of the utmost importance that such reforms are stepped up now that EU accession has taken place. Only in this manner will participation in the EU act as a catalyst for Croatia to evolve towards a more prosperous economy. In achieving this aim, a lot will depend on political will, social cohesion and a fruitful partnership with the European institutions and the other Member States.