CROATIA

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1. Introduction

This paper is based on statistical information from the Croatian Bureau of Statistics (CBS), EBRD, Standard & Poor's Sovereign Ratings Service, and data provided to standardized questionnaire by Mr. Predrag Bejakovic from the Institute for Public Finance, Zagreb. Opinions and conclusions further provided are based on interviews with Ms Marina Kesner-Skreb and Mr. Anto Bajo from the Institute for Public Finance, Mr. Sasa Madzarevic from the Ministry of Finance, and Ms Igeta Drinovac and Mr. Vedran Sosic from the research department of the National Bank of Croatia (HNB), as well as personal observations of the author who has visited Croatia in May 1997 and 21-23 April 1999.

2. Country background.

On 25 June 1991 Croatia and Slovenia declared independence. After a 6 month war with Yugoslav army and Serb militias a peace agreement between Croatia and Yugoslavia was signed on 2 January 1992. Shortly after Croatia gained international recognition as independent State. However, up until the Dayton Agreement of 1995 Croatia was involved in the Bosnia conflict.

3. Economic facts

3.1. Size and structure of the economy

Table 1 Nominal GDP in USD

	1992	1993	1994	1995	1996	1997	1998*
Nominal GDP (in $)	**10 241**	**10 871**	**14 592**	**18 811**	**19 738**	**19 321**	**21 600**

*** Estimate**

GDP per capita has increased from about $2200 in 1992 to some $4700 in 1998. For 1995-1998 Croatian economy recorded a real GDP growth of 20%, or 4,5% annually on the average. The 1998 GDP level reached 76% of the pre-independence level in 1990. Inflation has been kept low - CPI averaged 3,7% for the period of 1995-1998 while PPI averaged the modest 0,8% for the same period. The foreign exchange reserves of the HNB increased from $ 1 895 m to $ 2 816 m in 1998. Gross government debt increased from 17,9% of GDP in 1995 to 25% of GDP in 1998. Unemployment rate increased from 14,5% to 18% during the same period. Budget deficits averaged to 1,2% of GDP in 1995-1997, and 1998 marked a modest surplus of 1% of GDP. Major share of GDP is held by the service sector - 65%, industry comes next with 25%, and agriculture contributes to 10%.

Table 2 Companies and employment by sectors

Registered companies (June 1998)	Industry	Agriculture&Forestry	Construction	Trade	Transport	Services	Finances	Other	Total
Number	18 160	3 649	10 698	81 388	8 365	5 513	19 438	33 786	181 007
out of them private (%)	31,2	21,60	52,6	61,8	13,80	25,20	33,8	2,20	27,30
% of total	10,03	2,02	5,91	44,96	4,62	3,05	10,74	18,67	100,00
Number of employees	320 000	35 000	67 000	147 000	88 000	43 000	69 000	226 000	995 000
% of total	32,16	3,52	6,73	14,77	8,84	4,32	6,93	22,71	100,00
Average number of employees	17,62	9,59	6,26	1,81	10,52	7,80	3,55	6,69	5,50

per company									

The number of registered business entities increased for 74 000 in 1992 to 181 000 in June-1998, or an average annual growth pace of 13,3%. Major activities are trade (45% of the companies registered), finances (11%), industry (10%), construction (6%). Two sectors have distinct private ownership - trade with 61,8% and construction with 52,6%. Relatively low seems private involvement in services (25,2%) and transport (4,62%). **High level of state ownership in services and transport might lead to weak flexibility and adjustment to international or domestic adverse economic developments.**

3.1. Government Budget

Government expenditures accounted for 54,6% of GDP in 1998 and are scheduled for 57% in 1999. Their share has been constantly growing between 1995 and 1998 from 48,9% of GDP to 54,6% in 1998. Major revenue sources for 1998 were: VAT - 50% of total tax revenues, excises - 14,3%, personal income tax - 12,2%, taxes on international trade - 10,6%, etc. **The high share of VAT might be explained by the negative trade balance** since imports are taxed and exports are not. Major expenditure continues to be defense, with 10,9% of the central budget spending or some 2,6% of GDP. Capital expenditures accounted for 13% of total expenditures, with 10% dedicated to procurement of fixed capital assets. This item could be used as **first cushion to ameliorate fiscal gaps**[1]. Subsidies account for some 2% (although the trend is upward) of budget expenditure, or 0.5% of GDP and are mainly directed to agriculture and shipyards.

Two facts related local budgets are important: first, local authorities cannot borrow abroad, and second, local authorities of cities bigger than 40 000 have the right to determine so-called "surcharge" above the "federal" personal income tax within 5-18 percentage points range. **The latter provides for certain regional fiscal competition which can be used by local governments to attract investment through tax tools. At the same time, the ban on external borrowing guarantees long-term central control over the size of public debt.**

The pension fund is separated by the central budget, but still relies on transfers from the budget. Its level for 1998 was about DEM 260 m.

The government is allowed borrow up to 5% of GDP from the Central Bank but all amounts should be repaid by the end of the year. The maximum amount of the pro-inflationary refinancing is about 36% of the foreign exchange reserves of the HNB.

3.2. Financial Sector

60% of banking system assets are held by state-owned banks, according to the Institute for Public Finance, and in 1997 the four biggest banks held 57% of the assets. According to EBRD however, private banks hold 64% of the assets. The number of commercial banks increased during the credit expansion in 1997 when domestic credit jumped by 44%. High interest spreads between lending and saving rates attracted new investors, according to analysts from the HNB. Capital requirements are complied with the Basle standards, with 8% capital adequacy ratio and minimum equity requirement of appr. $ 7,8 m for bank with foreign exchange operations and appr. $ 2,6 m for domestic license. Experience and educational requirements are set for bank management. The number of banks is slowly decreasing. In 1998 the deposit withdrawal harmed only relatively small banks, while at the same time deposits in larger banks increased by comparable volume (about DM 800 m). According to S&P the sector is still fragile and overpopulated, though asset quality was improved through the ongoing rehabilitation of major state-owned banks.

Croatia also enjoys relatively high rate of domestic savings which could foster further increase in investment.

[1] The upcoming revision of the 1999 Budget plans a major cut in capital expenditure.

Table 3 Savings and Investment

Year	1995	1996	1997	1998
Gross domestic savings as % of GDP	12,0	17,6	11,5	17,4
Gross domestic investment as % of GDP	18,8	22,1	23,9	24,9

Source: S&P Sovereign Ratings Service

3.3. Debt Management

Total external debt increased from 24% of GDP in 1995 to 39% of GDP in 1998. Private external debt for 1998 was about 13% of GDP, or one third of total foreign debt. Domestic public debt decreased from 16,7% of GDP in 1995 to 10% in 1998. Interest payments scheduled for 1999 account for some 1,4% of GDP. The biggest share of domestic debt is comprised of obligations to repay foreign exchange deposits (which were frozen in 1993-1996). The amount is $ 900 m (41% of total domestic debt outstanding) and is due in 2005 with annual interest rate of 5%. About 71% of the debt is due before 2010. T-bills account for $120 m, or 5,5% of total domestic debt.
External debt service accounted for 14,9% of exports in 1995, reached 20% in 1998 and is expected to be 25% in 1999.

Table 4 Major Debt Indicators

	1995	1996	1997	1998
Gross external debt (USD m)	4 538	4 808	6 662	8 197
Gross domestic debt (USD m*)	3 137	3 045	2 371	2 154
External debt service as % of exports	14,9	12,9	16,3	20,0
Share of general government gross debt denominated in local currency	93,2	56,2	55,6	40,0

* estimated at annual average exchange rate
Source: S&P Sovereign Ratings Service; Ministry of Finance

3.4. Foreign trade and major partners

Foreign trade as share of GDP ranged between 60,8% (in 1998) and 68,7% (in 1997) for the 1995-1998 period. The USD volumes range between $ 12 billion and $ 13 billion.
Between 1995 and 1997 the trade deficit increased from $3,2 billion to $5 billion, or 17% and 26% of GDP, respectively. In 1998, the trade deficit lowered to %3,9 billion, or 18% of GDP. Tourism covered 50% of the trade deficit in 1998 according to the country presentation on 1999 EBRD Annual Meeting in London (Institute for Public Finance estimate tourism revenues for 1998 at $ 2,7 billion). Major export destinations are the EU - 45% of total exports, CEFTA - 16,4% and other European developing economies - 23,6% (data for 1997).

Table 5 Foreign trade with Balkan countries in USD million in 1998

Countries	**Trade flows**	
Albania	Imports	Exports
Bulgaria	0	5
Bosnia & Herzegovina	156	654
Greece	0	0
Macedonia	56	64
Slovenia	722	432
Romania	15	7
Turkey	0	0
Yugoslavia	19	17

Trade with Balkan countries amounted to $ 2 140 m in 1998, or 16,6% of total foreign trade. Croatia is a net exporter to Balkan countries, with exports of $1 172 m (25,8% of total exports) and imports of $ 968 m (11,6% of total imports). **Major partners** in the region were **Slovenia** - exports of $ 432 m and imports of $ 722 m, and **Bosnia & Herzegovina** - exports of $ 654 m and imports of $ 156 m.

3.5. Institutional

State institutions of independent Croatia are relatively new. A quick overview of major institutional developments in the country follows:

- **Existing state monopolies**. At present, water and electricity supply, gas transmission, roads and telecommunications are government monopoly. Croatian Telecoms is scheduled for privatization in 1999. State monopoly in energy supply and transmission will remain. Concessions are to be applied to roads.
- **Capital markets**. Zagreb stock exchange which was found in 1918 was revived in 1991. It is registered as non-profit joint stock company. Members are banks and brokerage houses. Two smaller unofficial (OTC) markets operate in Varazdin and Osijek.
- **Deposit guarantee system**. Corporate accounts are not insured guaranteed. Private deposits are 100% insured up to the level of HRK 100000 (DEM 26000) per person (cumulative).
- **Registers**. Property register is centralized and based on property but not available in electronic form.
- **Bankruptcy**. Bankruptcy procedures are rarely used, average term is 12 months. Finance Ministry usually blocks accounts. Contract enforcement is poor.
- **Foreign exchange**. Foreigners are not allowed to buy HRK denominated debt.
- **Credit ratings.** Local currency: BBB+/Stable/A-2; foreign currency: BBB-/Stable/A-3.[2]
- **Fiscal system**. Treasury system was introduced in 1999.
- **Foreign trade.** WTO membership expected by end-1999

3.6. Political

The Constitution provided for a bicameral Parliament, a popular-vote-elected president and three-tier judiciary system. President elections are held once in 5 years, parliament (both lower and upper house) has 4 year term. Prime minister is nominated by the president and later approved by the Parliament. Franjo Tudjman has been president since 1990, and was re-elected in 1997 with another 5-year term. The country has had 3 governments for the last 9 years. President Tudjman is losing confidence - in January 1998 he was the second most respected person in the country, while in January 1999 he ranked 35th. At the same time his term ends in 2002. His major asset seems to be war and nationalism. He identifies independent Croatia with himself, claiming every political opponent as enemy of independence. At the same time moderates enjoy higher approval ratings than Mr Tudjman[3]. The next general elections are scheduled for Spring 2001. Serb, Hungarian and Roma ethnic parties exist. and Political protection is considered important in procurement tenders, privatization and access to subsidies.

4. Conclusions

1. With the fastest growing economy and the second highest GDP per capita in the region Croatia will survive the war in Yugoslavia with negligible to moderate losses**. Croatia is physically detachable from Balkan neighbors**. Zagreb is only 170 km away from the Trieste port in Italy. Both railway and road infrastructure allow for convenient transportation to EU member countries. **Croatia cannot be isolated by the West through any regional conflict coming from South and East. The only two countries**

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[2] S&P Sovereign Ratings Service

[3] Business Central Europe, February 1999

which could affect Croatian economic development in any meaningful way are Slovenia and Bosnia & Herzegovina.

2. Cooperation with international institutions seems, however fragile. After a 3-year IMF extended agreement worth $490 was signed in March 1997, the lack of progress in implementing the Dayton and Erdut peace accords caused delay of IMF Board approval for the first review of the program. The same reasons kept the World Bank and the EBRD out of the country after mid-1997. The EU financial assistance is limited to humanitarian aid, and the PHARE program was canceled in 1995. Furthermore, Croatia decided to stop making purchases under the agreement in the autumn of 1998. **The overall dependence on official foreign financing is low, which makes decision making relatively indifferent to IFI's support**.
3. Trade flows with Slovenia and Bosnia & Herzegovina are significant, amounting to 9% and 6,3% of overall foreign trade, respectively. Other countries have negligible share of Croatian trade. **Croatia is export-dependent on Bosnia & Herzegovina**, which accounts for 17% of Croatian exports.
4. Croatia will maintain high level of trade deficit. Its financing depends on tourism (about 50% for 1998), foreign direct investment and foreign private debt financing**.**

- **Tourists from former Yugoslavia count for 17% of total tourist-nights**, however, only 2% come from Bosnia & Herzegovina and the rest from Slovenia. Other emerging markets tourists count for 27% of tourist-nights. The dependence on emerging market tourist is relatively high - 44%. The direct impact from the war in Yugoslavia in terms of tourists from warfare countries is negligible. **Tourism industry however is sensitive to political instability which could undermine foreign exchange inflows in the future**.
- **Foreign direct investment have been a negligible source for current account financing**. Their level by September 1998 was $ 2 billion, $420 per capita, or 24% of the total external debt outstanding at the moment. Equity market is still underdeveloped with few stocks (such as Zagrebacka Banka and Pliva) traded on the floor. **The level of foreign equity investment is negligible for the moment**.
- At the same time, Croatia managed to finance huge current account deficits borrowing on international financial markets. After favorable credit ratings of **BBB-/Stable/A-3** on foreign currency debt were granted in January 1997, the government switched to foreign financing and the gross external debt (public and private) increased by 39% in 1997 and 23% in 1998. In March 1999 managed to place a EURO 300 m 7-year bond issue with annual coupon of 7,375%. The bonds provided a relatively cheap financing with 375 basis points spread over the German government bonds. The local currency component of government debt decreased from 93,2% in 1995 to 40% in 1998. **These mean that Croatian government is increasingly borrowing abroad, thus increasing the foreign exchange inflows, but at the same time increasing the default risk**.

5. Apart from its North East territories Croatia is ethnically uniform. Since the current ruling party and President Tudjman root their political legacy in the national independence and strength of the Republic, **in case of loss of confidence ethnic problems might be inspired for electoral purpose**.