The Croatian Economy on the Way to the EU: Structural Problems Need Resolving

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Press Release

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The Croatian Economy on the Way to the EU: Structural Problems Need Resolving

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In order to have capacity to cope with competitive pressures within the European Union, Croatia has to carry out comprehensive reforms aimed at resolving structural problems in the economy. This is the conclusion of the European Commission's Directorate General for Economic and Financial Affairs based on the 2009 Progress Reports. In this article we indicate what Croatia has to do in order to facilitate its economic integration with the EU.

The European Commission's Directorate General for Economic and Financial Affairs (DG ECFIN) has recently published its comments on the economic chapters of the 2009 Progress Reports for the candidate countries (Croatia, Macedonia and Turkey) and potential candidate countries (Albania, Bosnia and Herzegovina, Montenegro, Serbia and Kosovo)[1]. In this article we summarize the main findings for Croatia and compare them with the results for countries in the region.

1 The Copenhagen criteria and Croatia

In 1993, the European Council identified in Copenhagen the basic economic criteria for the EU accession. They include two sets of criteria: the existence of a functioning market economy and the capacity to cope with competitive pressures and market forces within the EU. The general assessment of the ECFIN is that Croatia is a functioning market economy and that it will be capable of coping with competitive pressures within the EU, provided, however, that it implements comprehensive reforms in order to overcome structural problems. The explanation of these statements is given below.

Macroeconomic stability

Regarding the functioning of the economy, the ECFIN highlights macroeconomic stability which remains preserved in 2009, due to a prudent monetary policy. The central bank, through its regulatory changes, has successfully prevented the undermining of the financial stability, i.e. further escalation of the economic crisis. The banking system remains resilient to shocks, exchange rate stability has been maintained and inflationary pressures have eased. The fiscal policy has also played a positive role in introducing some cuts on spending and taking measures to compensate for declining budget revenues.

[1] European Commission (2009) "Progress towards meeting the economic criteria for accession: the assessments of the 2009 Progress Reports". Directorate General for Economic and Financial Affairs, Occasional Papers, No. 57, November 2009: http://ec.europa.eu/economy_finance/publications/publication_summary16140_en.htm.

Growing general government debt

Despite budget revisions, the planned budget deficit for 2009 climbed from 1.4% of GDP in 2008 to 3.3% of GDP. At the same time, the share of general government debt in GDP and the share of loans to government in total bank loans also increased. At end-2008, general government debt stood at 33.5% of GDP, only slightly more than a year before, but it increased again markedly in the first half of 2009 (the exact figure is not available in the ECFIN document[2]). Adjusted for issued state guarantees and the debt of the HBOR, total debt increases by additional 10 percentage points. Very limited progress has been achieved in the rationalisation of government spending which is one of the key Accession Partnership[3] priorities.

Inefficient public spending

Apart from minor improvements in the health care system (changes in co-payments), the Government has undertaken no reforms towards better targeting of social support. For example, no progress has been achieved in the pension system reform. In this respect, the ECFIN puts emphasis on generous early retirement rules. The public spending efficiency is low, as is the fiscal transparency. Moreover, in the budgeting process account should be taken of medium-term economic policy priorities while trying to reduce budget rigidities, i.e. fixed predetermination of expenditures. Furthermore, there is a need to improve co-ordination within the Government, as well as between the Government and the CNB.

The role of the state and business environment

Privatisation has also progressed slowly, so that the state continues to play a strong role in the real sector. The private sector's share in total employment stands at around 70%, and there are still over 800 unsold companies in the Croatian Privatisation Fund's portfolio, with the state having majority stakes in 85 of them. Improving the business environment is also a key Accession Partnership priority. In this respect, there are still difficulties in obtaining various licenses, whereas a large number of para-fiscal taxes significantly increase the pressure on entrepreneurs. The business environment is also affected by a still inefficient judicial system. Despite some progress, there is still a large backlog of cases before the courts; problems with the execution of court decisions persist and the land register remains incomplete.

Human and physical capital

Regarding competitive pressures Croatia will be facing after its EU accession, the ECFIN points to several problems, primarily the inefficiency and poor management in higher education affecting the quality of human capital. Another problem concerns the labour market which is characterised by low employment and participation rates (56.5% and 62.6% respectively in the first quarter of 2009), high youth unemployment and long-term unemployment rates (22% and 5.3% respectively), as well as mismatches between labour supply and demand. The first half of 2009 saw a further deterioration of the said indicators. The third problem relates to low private investments in industry constraining prospects for faster technological change, a more diversified production structure and higher export potential.

Further reforms and vulnerabilities

The privatisation of loss-making shipyards is also a key Accession Partnership priority. Apart from this, the following actions should be undertaken:

- the restructuring of the Croatian railway carrier (Hrvatske željeznice) and electricity company (Hrvatska elektroprivreda);
- further liberalisation of the telecommunication and industry sectors;
- strengthening the role of the SME sector in the economy;

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[2] The data provided by the Croatian Ministry of Finance are slightly different. The share of general government debt in GDP stood at 33.1% at end- 2007, 29.1% at end-2008 and 32.4% at end-June 2009. Including state guarantees and the HBOR debt, the share of debt in GDP goes up by additional 13.8 (10.4 + 3.4) percentage points, which makes a total of 46.2% of GDP. Source: Ministry of Finance of the RC, Statistical Review No. 166.

[3] Accession Partnership is a document adopted by the Council, which sets out the European Union's views of the short-term and medium-term priorities in the accession process for candidate countries.

- reducing state subsidies and guarantees, particularly for loss-making enterprises.

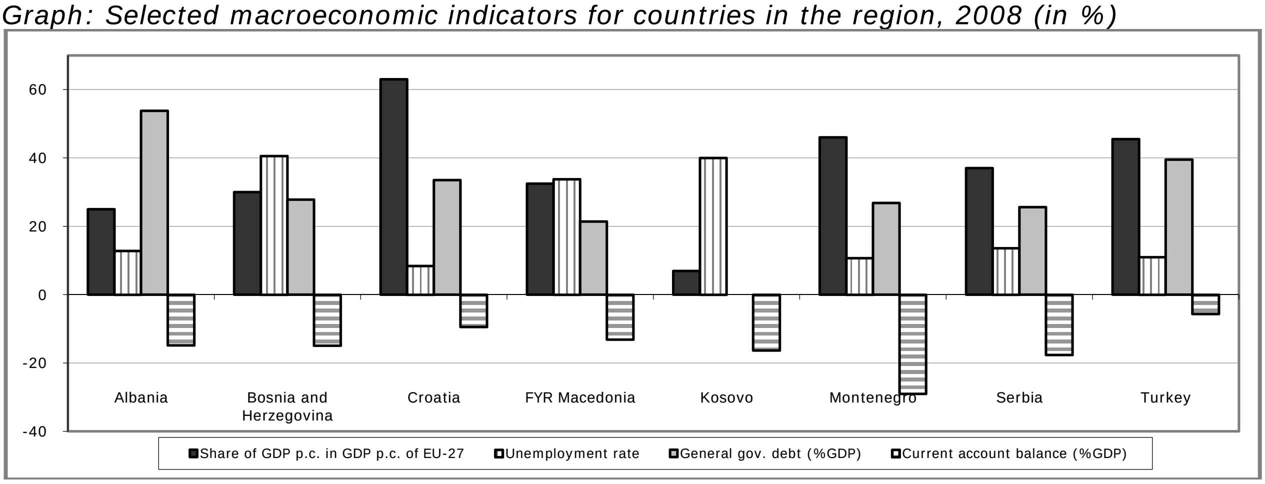
An important issue is also the export price competitiveness, which has to do with stronger growth of wages than the growth of average labour productivity in Croatia, as well as with exchange rate. According to the ECFIN, a high external debt level and large debt obligations maturing in the short-term represent key external vulnerabilities of the Croatian economy.

2 Neighbouring countries

Neighbouring countries have been facing very similar structural challenges. Here we only set out some major differences compared to Croatia. For example, the Former Yugoslav Republic of Macedonia has a very high unemployment rate (32.7% in the first half of 2009, compared with 9.2% in Croatia). At the same time, the share of general government debt in GDP is about 10 percentage points lower than that in Croatia, and privatisation is largely completed, so that the share of the private sector in total employment exceeds 80%. The banking sector of Turkey is less privatised than that of Croatia, but this country has launched its electricity grid privatisation. Whilst the share of the state in Albania's power sector decreased, unemployment remains high, traffic infrastructure is poor, the share of general government deficit in GDP stood at 5.5% of GDP in 2008 (compared with 1.4% in Croatia), etc. Unemployment rate in Bosnia and Herzegovina has reached a high of 40%, and a Stand-by Arrangement with the IMF has been concluded. Wages rose by about 17% in 2008 (7% in Croatia) and wage-setting mechanisms are distorted. Montenegro has experienced a sharp decline in industrial production as a result of reduced foreign demand and falling international steel and aluminium prices, so that these industries need restructuring. The financial sector suffered a severe liquidity crunch early in 2009, due to massive deposit withdrawals. There has also been a mismatch between labour supply and demand, forcing the Government to resort to foreign workers. As a result of deteriorated macroeconomic stability, Serbia requested assistance from the IMF and the EU, primarily for curbing government spending, whereas the central bank struggles with high inflation (10% in the first half of 2009, relative to the same period last year). Kosovo has a large trade deficit (in 2008, it stood at 16.3% of GDP compared with 9.4% of GDP in Croatia), high unemployment rate (40%), a very poor level of infrastructure, etc. All the countries are confronted with the challenge of informal economy.

The graph below shows a number of macroeconomic indicators for the said countries for 2008. According to the conclusions from the ECFIN document for each country, the Croatian economy seems to be the most advanced among the countries in the region in the process of EU integration. However, the graph also points to a serious problem for Croatia, i.e. the general government debt. Additionally, the country's external debt stood at 82.6% of GDP in 2008.

Graph: Selected macroeconomic indicators for countries in the region, 2008 (in %)



Note: The data on the share of general government debt in GDP for Kosovo is not available.
Source: European Commission (2009) and Eurostat.