73rd East Jour Fixe: Croatia – The 28th EU Member State

Compiled by Isabella Moder and Katharina Steiner[1]

Introduction

The OeNB's 73rd East Jour Fixe on June 17, 2013, focused on Croatia, which will become the 28th Member State of the European Union on July 1, 2013. The event dealt with structural reforms designed to boost growth and convergence in Croatia and provided an assessment of the impact of EU accession on regional trade patterns. In addition, speakers explored ways to ensure and enhance macrofinancial stability in Croatia. To conclude, the future of the Western Balkans was discussed from a political point of view. The following review provides a summary of the main issues discussed at the event.

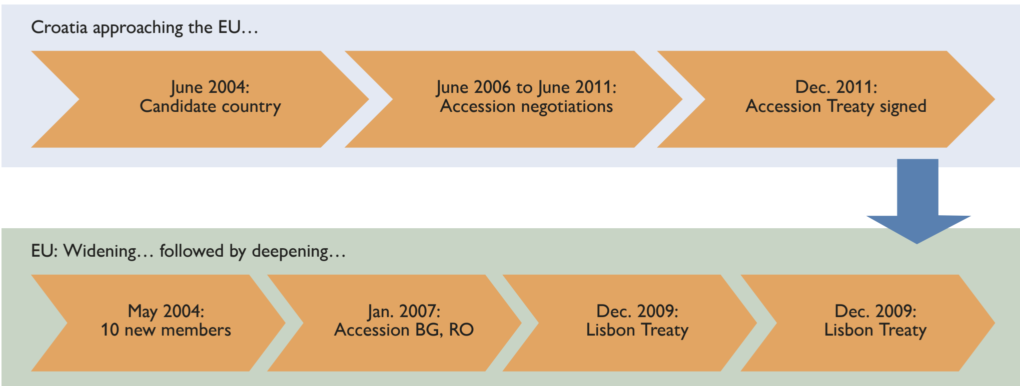
The EU – A "Moving Target"

Peter Mooslechner, Executive Director of the OeNB, opened the event by highlighting that Croatia's road toward EU membership had resembled an effort at approaching a "moving target" in difficult times. During the first years of Croatia's accession process, the EU experienced two major waves of enlargement, growing to comprise a total of 27 Member States by 2007.

Then in 2008, the EU was fully hit by the outbreak of the economic and financial crisis, and – as a response to an environment characterized by macroeconomic changes – it has since seen an unprecedented deepening of economic governance. At the same time, Croatia, as well as the rest of the CESEE region, had to cope with enormous macroeconomic challenges: With the beginning of the crisis in 2008, the catching-up process vis-à-vis the EU nearly came to a halt or even reversed in some countries (in terms of GDP per capita). In light of these recent economic and region-wide developments, Peter Mooslechner pointed out that although Croatia's EU accession is a major accomplishment, it also entails a number

Chart 1

Croatia's Run-Up to EU Membership – Approaching a "Moving Target" in Difficult Times…



Source: OeNB.

[1] *Compiled on the basis of notes taken by Leonie Decrinis, Mariya Hake, Mathias Lahnsteiner, Josef Schreiner, Tomáš Slačík (all OeNB, Foreign Research Division) and Sandra Dvorsky (OeNB, European Affairs and International Financial Organizations Division).*

of new challenges for Croatia: The country is about to join the EU in a difficult macroeconomic environment; at the same time, strengthened economic governance in the EU will reduce the scope for national policymaking. Moreover, enhanced surveillance will have implications for Croatia's monetary convergence process (ERM II accession, euro adoption).

The Hrvatska narodna banka (HNB) and the OeNB have been cooperating successfully for many years. Among other activities, so-called "informal dialogue" meetings between the two institutions were established in April 2006; preparations for this year's meeting are currently underway. The prime topics covered by the "informal dialogue" were Croatia's progress in the EU accession negotiations as well as practical aspects and institutional topics including institutional changes at the EU level. In addition, financial stability issues have been, and will remain, an integral part of each dialogue meeting.

Reforms Are Difficult but Crucial in Challenging Times

In his keynote address, *Paul Vandoren,* Head of the Delegation of the European Union to the Republic of Croatia, elaborated on opportunities and challenges in the context of Croatia's EU accession. He, too, pointed out that Croatia enters the European Union in a difficult economic environment that demands continuing reform efforts, which shall not ease after accession on July 1, 2013. Greater efforts will be necessary in order to cope with competitive pressures and to fully reap the benefits of access to the single European market, which Vandoren identified as the most important benefit for Croatia after EU accession. A further important benefit relates to the increasing availability of EU funds, which has the potential to boost the Croatian economy provided that proper funding priorities are defined at the national, regional and local level, the administrative capacity to manage those funds is put in place and cofunding requirements are met. He further laid out the country's economic potential, which, among other things, consists in its attractiveness as a tourist destination and its scope for attracting more foreign direct investment (FDI, in particular greenfield investment). In order to do so, however, problems in relation to (perceived) corruption, red tape and the judicial system's persistent lack of efficiency need to be addressed. Further challenges for Croatia relate to reviving job-rich growth, strengthening public finances, promoting competitiveness and, more generally, adapting to a dynamic economic environment.

Discussing Croatia's (Lack of) Competitiveness and Potential Sources of Growth

The first session, chaired by *Thomas Gruber,* Head of the Central, Eastern and Southeastern European Analysis Unit (Foreign Research Division, OeNB), was dedicated to real economic developments. *Sanja Madzarevic-Sujster,* Senior Country Economist at the World Bank Croatia Office, focused on the status quo of, and way forward for, market reforms in Croatia in her presentation. Prior to the financial and economic crisis, the key driver of economic growth had been capital accumulation, especially in the area of civilian construction. By comparison, the contributions of total factor productivity and labor were very limited compared to other Central European economies. This implies that existing resources could have been used more efficiently but also that total factor productivity and labor could be potential growth drivers in the future. Since the onset of the crisis, Croatia's competitiveness has declined. The Croatian economy's main weaknesses are insufficiently developed institutional settings, a lack of innovation and the labor market, which has the lowest participation and employment rate in the entire European Union. Especially for young people, labor market entry is constrained. Thus, apart from several measures to improve the investment climate in Croatia, reforms to increase labor market flexibility will also be necessary. Currently, macroeconomic vulnerabilities mainly stem from the fiscal position and high external debt. All this means that basing the growth strategy on further capital accumulation and high levels of external financing is unrealistic and expenditure-based consolidation remains a priority. Considering these fiscal constraints, the EU structural funds that Croatia will receive present an opportunity. However, having the right development strategies and sufficient fiscal space for cofinancing is important to absorb these funds and prevent them from being used for "roads leading to nowhere."

The issues of competitiveness and investment climate were also referred to by the next speaker, *William Bartlett,* Senior Research Fellow at The London School of Economics and Political Science, who discussed whether Croatia is catching up or falling behind. In order to catch up, it is necessary to be able to absorb new technologies, attract capital and participate in global markets. Other important factors are institutions that provide incentives for investment and competitiveness as well as productive entrepreneurship. When looking at FDI inflows, there was a noticeable increase from 2006 to 2008. In the course of the crisis, FDI plunged and has not picked up again since. Goods exports also decreased sharply in 2009, but goods exports managed to return to the 2008 level by 2011. Given Croatia's comparatively weak external competitiveness, a capital inflow-based growth model is currently not an option; instead, internal sources of growth need to be tapped. Unlike the previous speaker, Bartlett argued that public expenditure should not be cut and said he favored a more efficient way of conducting fiscal policy and an increase of spending in the education sector. This could be financed by additional taxes when incorporating the grey sector into the economy and would thus not increase public debt.

What Impact Will EU Accession Have on Regional Trade Patterns?

Mario Holzner, economist at the Vienna Institute for International Economic Studies, discussed whether and how EU accession will change Croatia's trade flows with its neighboring non-EU countries. In a first step, he looked at past experience from Croatia joining the Central European Free Trade Agreement (CEFTA) in 2007. Since then, surprisingly little has changed in the country's trade structure except for a slight change of imports, related to lower demand for investment goods during the crisis. In a next step, Holzner analyzed whether EU accession will differ markedly from being subject to the CEFTA agreement, and what is to be expected from EU accession. To address this question, he introduced a partial equilibrium model on trade and tariffs to analyze total real trade flows. The model only incorporates first-round effects and is based on a scenario of zero percent tariff rates for trade between Croatia and the EU and the EU bilateral tariff rates for Croatia's trade with CEFTA and the rest of the world. The results of the simulations indicate only little change for Croatia's exports except for a moderate reduction of exports to Serbia and Kosovo. In parallel, exports to the rest of the world will also decline modestly, while there will be gains from increased exports to the EU. Also, domestic sales are expected to fall moderately. An analysis of possible welfare changes indicates that consumer prices in Croatia might fall by 0.39% and real output by 0.41% in the short run. In other words, Croatian production might suffer a bit after EU accession; however, as Holzner argued, EU funds will compensate this loss many times over.

Nonperforming Loans Weigh on Future Credit Growth

Financial stability aspects were at the core of session 2. *Tomislav Galac,* Chief Advisor at the HNB, briefly described the main features of the Croatian banking sector, which is historically characterized by high capital adequacy and a high level of liquidity. However, nonperforming loans (NPLs), which are particularly high in the nonfinancial corporate sector, and the relatively low NPL coverage ratio may dampen future credit growth. A comparison with other CESEE countries reveals that Croatia's overall NPL ratio is in the middle range – with the caveat that NPL data that are harmonized across all countries are not available. Galac further shared his opinion that Croatia's relatively low NPL coverage ratio does not give cause for major concerns since, and as long as, banks' capital adequacy is high. Overall, for short-term NPL resolution, institutions need to find an optimal balance between an early collection of NPLs (or the collateral attached to them) on the one hand and the restructuring of NPLs on the other hand. In the long run, the government needs to improve institutions and rules related to NPL resolution.

Another issue with respect to macrofinancial stability is the country's persistently high degree of financial euroization. Measures to address this issue during the period from 2004 to 2008 proved to be only partly and temporarily effective. Some recommendations by the European Systemic Risk Board (ESRB) have already been implemented, but rules on required reserves on foreign currency loans and limits to foreign currency funding still have to be introduced. Overall, the HNB is reviewing its microprudential measures for procyclicality but credit institutions also have to contribute their share in promoting lending to new creditworthy clients, Galac highlighted. Since 2012, credit growth in Croatia has been stalling, and both supply and demand are to be blamed. The ensuing panel discussion with representatives of Austrian and Croatian commercial banks as well as participants arguing from the supervisory perspective was chaired by *Peter Backé,* Deputy Head of the OeNB's Foreign Research Division, and dealt with the issues raised by Tomislav Galac in greater detail. Overall, the panelists shared the view that, as the economy is being hit by long-lasting recession, NPLs are the main risk for macrofinancial stability and that NPL resolution is key to future credit growth in Croatia.

Both *Hrvoje Dolenec,* Chief Economist with Zagrebacka banka d.d. (UniCredit Group), and *Birgit Niessner,* Chief Analyst of CEE Macro/Fixed Income Research (Erste Group Bank AG), started off by saying that the Croatian financial sector is an asset – not a liability – to the economy. Recently, banks in Croatia have been facing deleveraging in the household and corporate sectors, paired with fairly strong credit demand from the public sector. In the past, credit flows were tilted to the nontradable sectors, especially to the construction sector, as highlighted by Birgit Niessner. Today, however, due to demand and supply constraints, too little investment activity is financed – especially in manufacturing and the SME sector.

Franz Pauer, Senior Expert with the OeNB's Financial Markets Analysis and Surveillance Division, discussed the main factors behind stalled credit growth. He argued that on the supply side, capitalization and liquidity were no restricting factors, but that risk awareness had increased and that obstacles in the collection of collateral were hampering credit supply, too. On the demand side, indebtedness of households caused by consumption purposes is already high, and demand is low in view of the economic recession. Franz Pauer also elaborated on the macroprudential measure, the so-called Loan-to-Local Stable Funding Ratio (LLSFR), implemented to improve the funding structure of Austrian banks not only in Croatia, but in all countries hosting Austrian banks' subsidiaries. The panel concluded by highlighting the need for the supply of new credit for profitable investment projects and for higher risk-bearing capacity. However, restarting credit growth is difficult due to the comparatively high leverage of the Croatian economy and will therefore take some time.

Clearer Accession Perspective Needed for Western Balkans

The OeNB's 73rd East Jour Fixe concluded with a discussion of the future of the Western Balkans region from a broader political perspective and the point of view of EU integration. *Wolfgang Petritsch,* Austria's Ambassador to the OECD, started out by highlighting that the recent history of the Western Balkans has been dominated by the relations between Serbs and Croats on the one hand and by the Kosovo question on the other. While some challenges – such as the name issue regarding the Former Yugoslav Republic of Macedonia or the weak level of federal state power in Bosnia-Herzegovina – remain, others – such as the Kosovo issue – seem to stand a good chance of being resolved, not least thanks to the "soft power" of the EU. Against this background, however, Petritsch stressed that the EU will have to fundamentally overhaul its strategy vis-à-vis the Western Balkans since conditionality related to the prospect of eventual EU membership has been losing power as a political tool to bring about reforms and institutional change. This is also due to the fact that Russia and Turkey are establishing themselves as major players in Southeastern Europe, in addition to the European Union. While for the EU, which aims at creating a peaceful unified Europe, the Western Balkans are particularly a political issue, Russia's and Turkey's main interest is in economic opportunities. Thus, Petritsch urged the EU to give the Western Balkan countries and – most of all – its citizens a clearer accession perspective, as intended in the EU's Thessaloniki Declaration of 2003. In this respect, he called on Croatia to play a brokering and catalyzing role in the process of further integrating the Western Balkans and thereby promote the further unification of Europe.

Annex: Croatia – Facts and Figures (2012)

Table A1

Croatia – Selected Indicators

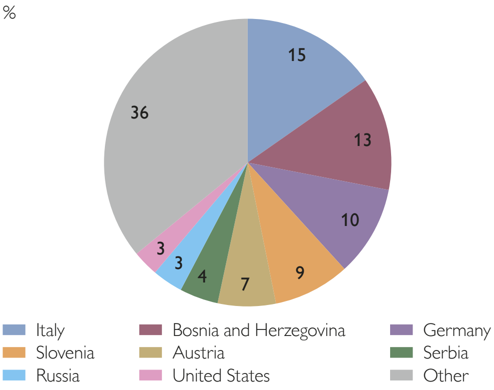
Key figures	
Population in million	4.4
GDP in EUR billion	43.9
GDP per capita in purchasing power standards, % of EU-27 average	58.1
Gross value added (data for 2011)	
Agriculture, forestry and fishery in % of total gross value added	4.9
Industry excluding construction in % of total gross value added	20.6
Building and construction in % of total gross value added	6.0
Services in % of gross total value added	68.5
Financial sector	
Total assets in % of GDP	123.5
Foreign ownership share of banks in % (data for 2011)	90.6
Nonperforming loans in % of total loans	10.1

Source: Ameco, IMF, HNB, EBRD.

Note: Unless otherwise stated values refer to 2012.

Chart A1

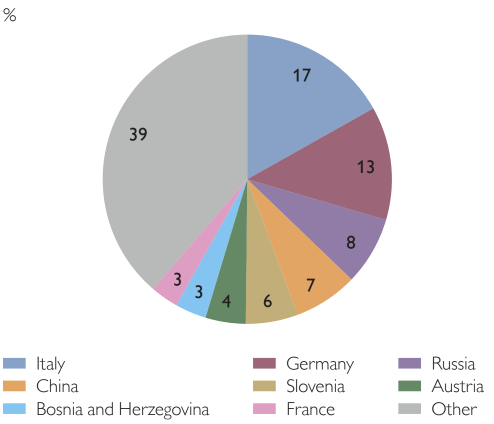
External Sector: Exports by Country



Source: wiiw.

Chart A2

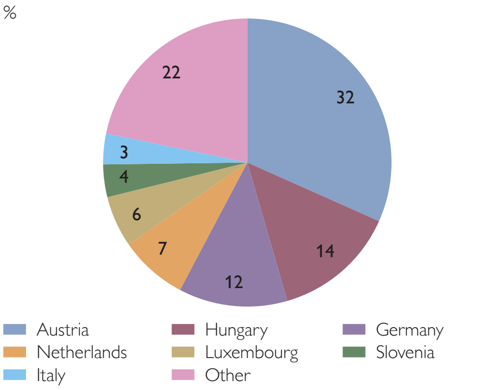
External Sector: Imports by Country



Source: wiiw.

Chart A3

External Sector: Inward FDI by Country of Origin



Source: wiiw.