

# Croatian Economic Outlook

## Quarterly



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## Forecast Update

### Croatian GDP expected to pick up

Real GDP increased by 1.2 percent in the second quarter of 2015 when compared to the same period in the previous year, while seasonally adjusted GDP went up by 0.5 percent when compared to the first quarter of 2015, making it a fourth consecutive quarter-on-quarter positive output growth rate (Figure 1). We expect this pickup in activity to continue into the third quarter and to have an overall positive effect on the growth rate in 2015 as a whole. In light of the latest available data we have revised our GDP forecasts upward by 0.1 and 0.2 percentage points, which now stand at 0.5 and 1.1 percent for 2015 and 2016 (Figure 2).

### Global recovery continues along a sure-footed path

Positive developments in Croatia are closely linked to the global and European economic recovery. Global economy grew at a rate of 3.4 percent in 2014, 0.1 percentage point higher than in 2013, continuing sure-footedly along the path of recovery. The International Monetary Fund (World Economic Outlook Update, July 2015) projects a marginally lower world real GDP growth rate of 3.3 percent in 2015, followed by an acceleration of 3.8 percent in 2016.

### Eurozone's growth speeds up

Real GDP growth in the Eurozone is expected to pick up from 0.9 percent last year to 1.5 and 1.9 percent in this and the following



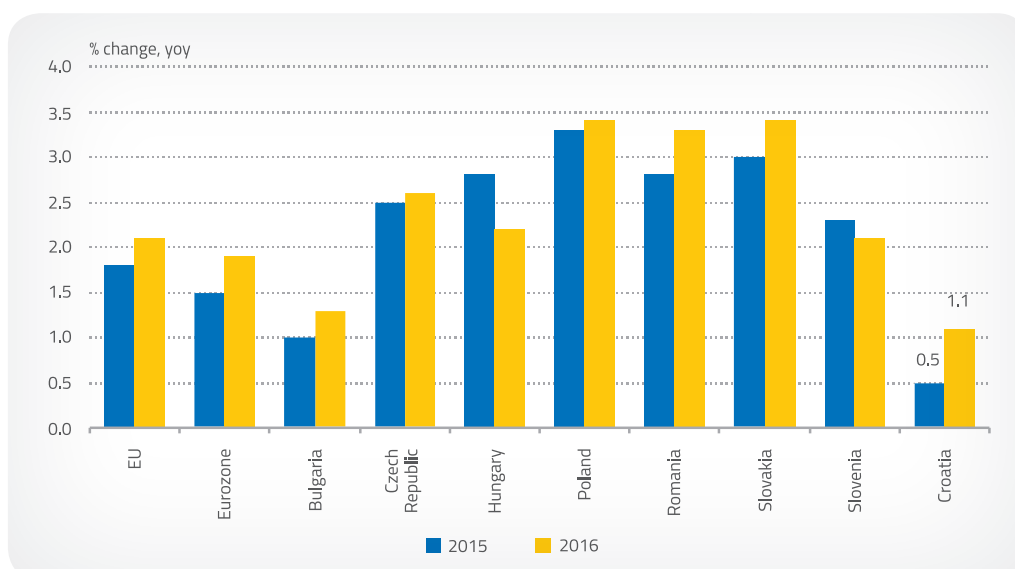
**Figure 1**  
Real Gross  
Domestic Product

**Note:** Seasonally adjusted by X11ARIMA (Statistics Canada).

**Source for original data:** Croatian Bureau of Statistics.

**Figure 2**  
Real GDP Growth Projections for Croatia and Selected CEE Countries

**Source:** European Economic Forecast, European Commission, spring 2015 and EIZ for Croatia.



year (European Economic Forecast, spring 2015). This optimistic outlook is backed up by improvements in domestic demand which remains the main contributor to GDP growth, low oil prices, increased international competitiveness of EU firms due to euro depreciation, and also improved financing conditions and availability of credit.

**Personal consumption shows signs of continuous recovery**

In the second quarter of this year seasonally adjusted personal consumption recorded a third consecutive quarter-on-quarter positive growth rate of 0.2 percent (Figure 3). Although personal consumption remains heavily influenced by low consumer sentiment and protracted deleveraging, positive signals from

the labor market, coupled with recent increase in nominal net wages and government announcements of policies introducing debt forgiveness and public utilities vouchers, give rise to a certain dose of optimism. This is reflected in an upward revision of our growth forecasts, which now stand at 0.3 and 0.4 percent for the current and the following year.

**Investment recovery kick-started in the second quarter and is set to increase further**

Seasonally adjusted investment activity in the second quarter of 2015 recorded zero growth when compared to the previous quarter (Figure 3). However, when compared to the same period last year it increased at a rate of 0.8 percent. This is mostly due to

**Figure 3**  
Personal Consumption and Investment

**Note:** Seasonally adjusted by X11ARIMA (Statistics Canada).

**Source for original data:** Croatian Bureau of Statistics.



faster-than-anticipated absorption of EU funds in the first six months of this year, but also due to a mild recovery of the construction sector at the beginning of the second quarter. With an increasing recovery pace of domestic activity, better-than-anticipated investment performance in the second quarter and with the assumption that some of the previously announced large-scale EU projects will take place by the end of this year we revised our investment growth forecast to 1.9 percent in 2015, up by 1.4 percentage points. We expect some leveling-off at the rate of 2.0 percent in 2016.

### Budget consolidation expected to come into focus at the beginning of 2016

In the second quarter of 2015 government consumption recorded negative seasonally adjusted growth of 0.3 percent when compared to the previous quarter. However, when compared to the same period a year before, government consumption increased by 0.5 percent in the first half of the year making us revise our previous forecast for 2015 up by half a percentage point or to 0.2 percent. Our figure for 2016 remains unchanged, at -1.4 percent.

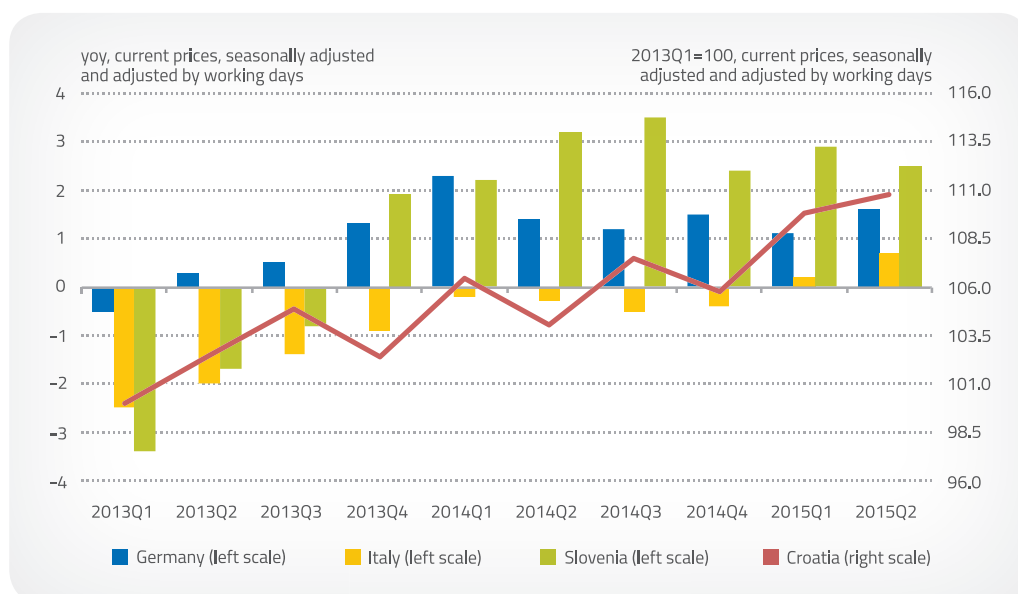
### Trade activity gained further momentum by mid-2015

Positive contribution of net exports to GDP growth, present since 2013, is expected to continue in the current and in the following

year. With respect to the first quarter of 2015, the second quarter saw seasonally adjusted export growth of 3.0 percent, reflecting mostly faster-than-expected recovery of our main trading partners (Figure 4). Meanwhile, imports followed by 1.9 percent growth in seasonally adjusted terms. Latest available data prompted us to revise upwards our projections for 2015 and 2016, which now stand at 5.7 and 5.2 percent for exports and 5.4 and 3.6 for imports. As the new import-export growth margins remained relatively unchanged, current account surplus projections stayed the same (Table 1).

### Incumbent Government speculates with the timing of general elections

According to the latest available information, the incoming general elections are most likely to take place in November this year. This information, however, is still unofficial, and the exact election day has yet to be decided upon. The media speculate that the beginning of November has been chosen as the „optimal“ solution, given that the ruling coalition would probably like to avoid for the elections to be held around this year’s anniversary of the fall of Vukovar (18 November). Judging by the unfortunate experiences from recent years, that occasion has been fertile ground for politically-motivated incidents and will likely ignite hard feelings and a destructive series of accusations between the left-wing ruling coalition and the main right-wing opposition



**Figure 4**  
Croatia's Exports of Goods and Services and GDP Growth Rate of Main Trading Partners

Source: Eurostat.

**Table 1**  
Forecast  
Summary

	2015	2016
<b>Real GDP (% change)</b>	<b>0.5</b>	<b>1.1</b>
Real private consumption (% change)	0.3	0.4
Real government consumption (% change)	0.2	-1.4
Real investment (% change)	1.9	2.0
Exports of goods and services (constant prices, % change)	5.7	5.2
Imports of goods and services (constant prices, % change)	5.4	3.6
Current account balance (% of GDP)	0.8	1.0
General government balance (ESA 2010 definition, % of GDP)	-5.5	-5.0
Unemployment rate (registered, %, pa)	18.0	17.6
Exchange rate, HRK/EUR (pa)	7.65	7.65
Broad money, M4 (% change, eop)	2.9	3.8
Total domestic credit (% change, eop)	-0.2	1.6
Consumer prices (% change, pa)	0.1	1.1

**Note:** Cut-off date for information used in the compilation of forecasts was September 7, 2015.

**Conventional abbreviations:** pa - period average, eop - end of period, HRK - Croatian kuna, EUR - euro.

**Source:** Authors' forecasts.

party. One must not forget, however, that it is the President who officially sets the date for the elections.

### Not proposing the Budget for the next year due to elections seems opportunistic

As expected, the Government did not propose the Budget for the next year, but rather opted only for temporary financing. On the one hand, this seems fair enough given that the current Government may not be in office next year. On the other hand, since Croatia is still subject to the Excessive Deficit Procedure, and thus under close scrutiny on the part of the European Commission (EC) concerning public finances, and since at the same time there is strong opposition to significant reforms on the part of different interest groups, giving up the opportunity to propose next year's Budget seems opportunistic. First, by doing so the ruling coalition avoids, or at least postpones, criticism by the EC for insufficient efforts towards consolidation. Second, it avoids losing some support just before the elections which, judging by the latest public polls, will be pretty tight.

### Elections-motivated legislative changes

Although one should perhaps not expect the current Government to try to improve its re-election probability by large outright populist spending increases intended to cheaply "buy" a portion of the electorate, the announcements of some legislative changes that should take place by the end of the term seem to be motivated, at least in timing, by the approaching elections. For instance, the Government passed a law that should solve the seemingly never-ending issue with the Swiss franc loans. Also, a law on personal bankruptcy, a law on civil victims of war and changes in the Law on Social Safety (larger transfers for some beneficiaries, vouchers for electricity) are proposed.

### Is the state budget improving?

For the first time since 2008 Ministry of finance reported a primary surplus in central government budget for the period between January and August this year (based on national accounting rules and the cash principle). When interest payments in the amount of 7.2 billion kuna are excluded, revenues have exceeded expenditures by 200 million kuna. Furthermore, VAT revenues

increased by 2.1 billion, excises by 500 million and corporate income tax by 700 million kuna over the same period last year. VAT revenues rose largely due to an increase in personal consumption, but also because of repaid arrears.

### **State of the overall government finance - still a mystery**

Although data up to September suggest improvements of the fiscal position, caution should be taken as the latest data represent only the central government budget based on the cash principle. However, even the statistics for the general government budget that have been published for the first quarter of 2015 are not comparable to last year as the scope of local government units and accounting rules have changed. The mystery surrounding the state of government finances is worrisome not only from an analytical or policy position, but also from the position of democratic control over the spending of public money. Therefore, to evaluate precisely the state of government finance, we have to wait for comparable general government data which may not appear before spring next year with the publication of ESA2010 data for 2015.

### **No significant fiscal consolidation efforts before 2016**

After public debt doubled from 2008 and continued to rise, the willingness of political institutions to implement policies that would result in sustainable public finances has been questionable. That being said, the upcoming parliamentary elections make any short-term reforms targeting fiscal sustainability even more unlikely. Moreover, recently implemented measures, such as changes within the personal income tax and debt relief for the very poor support this view.

### **Meeting the EDP targets seems implausible**

Taking into account all of the above and the measures drafted in the Convergence Program, the key document outlining fiscal policy measures and other related reforms in the next three years, as well as the National Reform Program, which describes measures

to cope with structural challenges, we expect the general government deficit in this year to be at around 5.5 percent of GDP, 2 percentage points above the EDP target. The newly elected government will probably be forced into more decisive reforms in 2016, but the deficit is still expected to be significantly above the EDP target of 2.7 percent – at around 5 percent of GDP. Public debt is expected to rise to 90 percent of GDP in 2015 and further to 93 percent of GDP in 2016.

### **Improvements on the labor market continue at a slow pace**

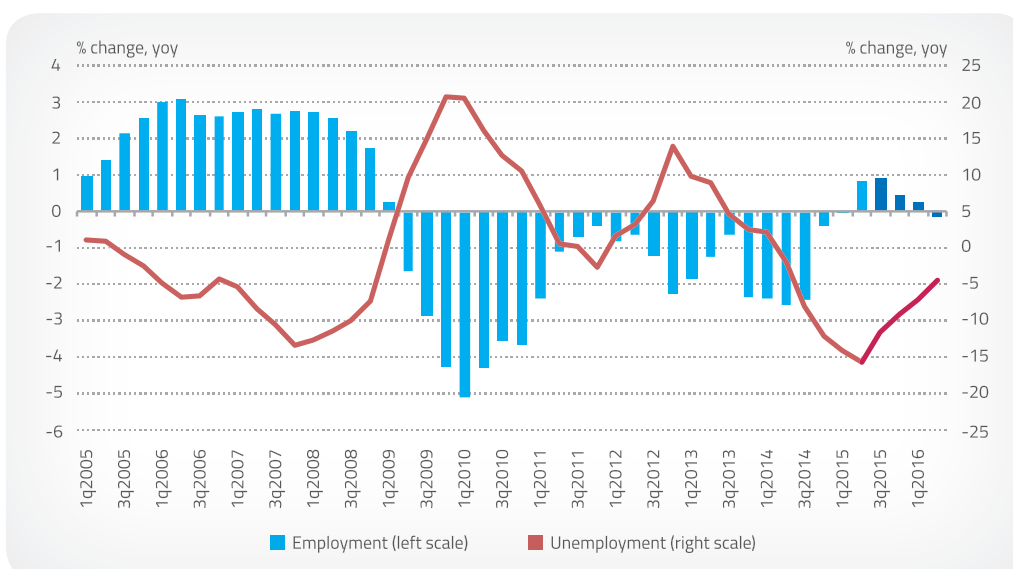
With both an increase in employment and a decrease in unemployment, the average registered unemployment rate in the first seven months of 2015 amounted to 18.2 percent; more than 2 percentage points lower than in the same period last year (20.5 percent). Most of the employment increase in the first seven months, in relation to the same period a year before, happened in accommodation and food service activities, and in professional, scientific and technical activities and administrative and support service activities. The fall of employment is observed mainly in real estate activities, agriculture, forestry and fishing and construction. Wages, on the other hand, rose primarily in real estate activities, electricity, gas, steam and air conditioning supply and mining and quarrying. Outflow from the register of unemployed declined in comparison to July 2014, mainly due to a decline in outflow for non-compliance with the legal provisions, while inflow into the register grew mostly because of an increase of unemployed that came directly from education. According to Eurostat, seasonally adjusted unemployment rate stood at 15.1 percent in July, which is the fourth largest unemployment rate in the EU, after Greece, Spain and Cyprus.

Although we expect unemployment to increase in the following months, as seasonal employment effects phase out, the average expected unemployment rate for 2015 is projected to remain at around 18 percent. For 2016 we see a slowdown in the fall of unemployment, mainly because the effect

**Figure 5**  
Total  
Employment and  
Unemployment

**Note:** 3q2015-  
2q2016 is based on  
extrapolated values.

**Sources:** Croatian  
Pension Insurance  
Institute (HZMO)  
and Croatian  
Employment Service  
(HZZ).



of non-compliance with the legal provisions of the registered unemployed will gradually fade out, and since we do not anticipate any significant rise in employment, the unemployment rate is projected to reach approximately 17.6 percent (Figure 5).

**Wages follow the general trend on the labor market**

Though average nominal gross wages have increased in the second quarter on both year-on-year, up by 1.5 percent, and quarter-on-quarter basis, up by 1.3 percent, we do not expect significant changes in 2015 (Figure 6). Next year, wages in the private sector could go up slightly, whereas in the public sector they could fall due to fiscal pressures from the EU, and thus bring an overall neutral effect. With the expected increase in consumer prices for

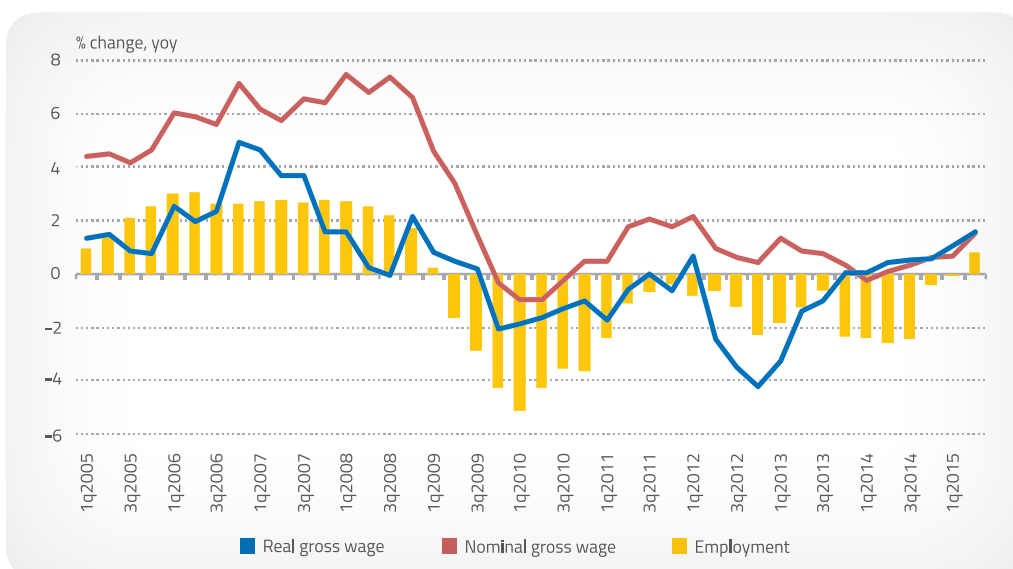
the next year, real wages could decrease, but the effect on overall real disposable income should be mitigated by a slight increase in employment.

**Prices still under pressure**

Having in mind the low Eurozone inflation, relatively low crude oil prices, weak demand-pull and cost-push inflation pressures in the domestic market, we expect consumer price inflation for this year to remain very low, at 0.1 percent on average. It seems that the recently ended six-year-long recession characterized by high unemployment, private sector deleveraging and decreasing unit labor costs still weighs on consumer prices. Meanwhile, as personal consumption gradually recovers next year, prices are expected to follow, leading the average consumer price index to 1.1 percent.

**Figure 6**  
Change in  
Employment and  
Wages

**Sources:** Croatian  
Pension Insurance  
Institute (HZMO)  
and Croatian Bureau of  
Statistics (DZS).



## CNB indirectly criticizes the law for Swiss franc loan resolution

As a response to the Government passing the law that should solve the issue with the Swiss franc loans, the central bank issued a report on the problem of loans in Swiss francs and the proposed measures. The report includes a discussion of seven different solutions but more importantly is also includes simulations with possible impacts on loan holders, banks, public finance and international reserves. Besides, the simulations made by the Croatian National Bank include other aspects as well, such as the social component of the proposed solutions or the duration of the impact in the sense of fiscal revenues accumulation, bank profit and international reserves depletion.

The proposed solutions are the following:

- (a) regulatory–tax measures;
- (b) taxation of bank assets in Swiss francs;
- (c) status quo (keeping the HRK/CHF exchange rate at the level of 6.39 and the interest rate on the level of 3.23 percent);
- (d) further decrease of the interest rate (down to 1 percent);
- (e) conversion to loans indexed to the HRK/EUR exchange rate without the impairment of principal;
- (f) conversion to loans indexed to the HRK/EUR exchange rate together with the impairment of principal - the government proposition;
- (g) conversion to local currency (kuna) loans - solution advocated by the association “Franak”.

The effect of these solutions on loan holders implies that conversions (e, f and g) place Swiss franc loan holders in a better position in relation to euro loan holders. Impacts of solutions a, b, c and d on bank profit are moderately weak, while all three of proposed conversions (e, f and g) have a high initial cost for the banks. All of the analyzed solutions have a certain negative impact on public finance, but in cases e and f this impact is fully concentrated in the next two or three years thus being the least favorable from the public finance point of view. Three of these solutions (a, b and d) have no impact on international reserves, and therefore, are preferred by the CNB. Finally, solutions a and b have a social component opposed to other solutions that have a linear impact on all loan holders.

Table 2 summarizes these impacts classifying them roughly as either “favorable” or “unfavorable”. According to that classification, solutions a and b seem to be the most favorable ones from the point of view of all interested parties. Solution d lacks the social component, while the status quo could potentially hurt international reserves. All three of the proposed conversions have unfavorable impacts on all interested parties. However, although not explored in the report of the central bank conversions are the only permanent solution and might prove to have benefits in the long run.

**Table 2** Impact of Proposed Solutions for Swiss Franc Loans

Solution	Loan holders	Bank profit	Public finance	International reserves	Social component	Permanent vs. temporary
a	favorable	favorable	favorable	favorable	favorable	unfavorable
b	favorable	favorable	favorable	favorable	favorable	unfavorable
c	favorable	favorable	favorable	unfavorable	unfavorable	unfavorable
d	favorable	favorable	favorable	favorable	unfavorable	unfavorable
e	unfavorable	unfavorable	unfavorable	unfavorable	unfavorable	favorable
f	unfavorable	unfavorable	unfavorable	unfavorable	unfavorable	favorable
g	unfavorable	unfavorable	favorable	unfavorable	unfavorable	favorable

Source: Croatian National Bank.

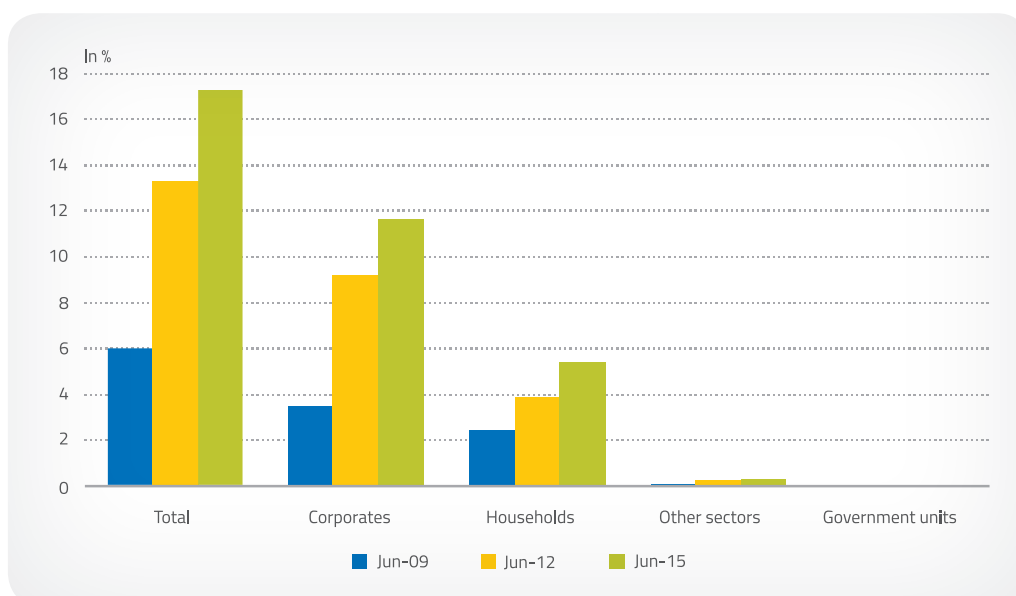
## High level of liquidity is not enough for credit recovery

Abundant liquidity coupled with historically low interest rates, and the liquidity buffers enabled by the Croatian National Bank seem

insufficient for domestic credit recovery. In this year financial weaknesses of both households and corporations on the demand side and poor growth prospects on the supply side will have an adverse effect on credit activity. Thus we

**Figure 7**  
Contribution  
to the Total  
Nonperforming  
Loans by Sectors

Source: Croatian  
National Bank.



expect negative credit growth to continue in this year, while a modest improvement of 1.6 percent in 2016 is mostly based on improved growth prospects.

### Stable HRK/EUR exchange rate

A successful tourist season helped kuna to stabilize in August after limited depreciation pressures in June and July caused by a repayment of a eurobond financed by a new issue of a six billion kuna ten-year bond. However, by the end of the year we expect kuna to depreciate mildly due to typical seasonal dynamics and possibly also due to the Swiss franc loans resolution. Taking into consideration the commitment of the central bank to defend the exchange rate, both in this and the following year, we see the HRK/EUR exchange rate remaining stable, at 7.65 on average.

### Elections bring a solution for Swiss franc loan holders

With parliamentary elections approaching, the Government proposed a solution for the 55,800 Swiss franc loan holders. According to this law that was univocally adopted by the Parliament, as of September 30 all Swiss franc loans can be converted to euro denominated loans at the market exchange rate on the date of loan issue. The Croatian National

Bank estimates that the potential cost of this proposal for banks is around 8 billion kuna. Foreign exchange reserves would have to be depleted in the euro equivalent of this amount in order to counteract the upward pressure on the HRK/EUR exchange rate, estimated at around 1 billion euros. Furthermore, it is possible in this scenario that bank profit is eliminated in the next three years leading to lower revenues from income tax. This will in turn either increase the budget deficit or require compensation measures on the fiscal revenues and/or the expenditure side.

### Share of nonperforming loans on the rise

By the end of June nonperforming loans (NPLs) increased by 354 million kuna when compared to the end of last year, bringing the share of NPLs in total loans up to 17.3 percent (Figure 7). The biggest contributors to NPLs are corporations and households, with the building sector leading in the corporate sector, and home together with general-purpose cash loans leading in the household sector. Having in mind that as much as 19.3 percent of all loans in Swiss francs have not been performing by the end of the second quarter, it is possible that the NPL ratio decreases in the months ahead in case the permanent solution for Swiss franc loans proves to be successful.



**Table 3** Main Economic Indicators

	2013	2014	2014		2015	
			Q3	Q4	Q1	Q2
<b>ECONOMIC ACTIVITY</b>						
Real GDP (% change, yoy)	-1.1	-0.4	-0.2	0.2	0.5	1.2
Real private consumption (% change, yoy)	-1.9	-0.7	-1.0	-0.5	0.3	0.6
Real government consumption (% change, yoy)	0.3	-1.9	-1.3	-0.5	0.6	0.4
Real investment (% change, yoy)	1.4	-3.6	-3.5	-4.1	-0.4	0.8
Industrial output (% change, yoy)	-1.8	1.2	0.4	4.1	-0.1	2.4
Unemployment rate (registered, %, pa)	20.2	19.6	17.6	19.0	20.1	17.2
Nominal GDP (EUR million)	43,591	43,110	-	-	-	-
GDP per capita (EUR)	10,242	10,130	-	-	-	-
<b>PRICES, WAGES AND EXCHANGE RATES</b>						
Implicit GDP deflator (% change, yoy)	0.9	0.0	0.4	0.4	0.3	0.4
Consumer prices (% change, yoy, pa)	2.2	-0.2	-0.2	0.0	-0.4	0.0
Producer prices (% change, yoy, pa)	0.5	-2.7	-2.9	-2.6	-4.1	-2.8
Average gross wage (% change, yoy, pa)	0.8	0.2	0.3	0.6	0.7	1.5
Exchange rate, HRK/EUR (pa)	7.57	7.63	7.61	7.66	7.68	7.57
Exchange rate, HRK/US\$ (pa)	5.71	5.75	5.74	6.13	6.81	6.86
<b>FOREIGN TRADE AND CAPITAL FLOWS</b>						
Exports of goods (EUR million)	9,589	10,369	2,716	2,755	2,573	2,923
Exports of goods (EUR, % change, yoy)	-0.4	8.1	4.2	5.0	9.2	15.0
Imports of goods (EUR million)	16,528	17,129	4,512	4,123	4,268	4,754
Imports of goods (EUR, % change, yoy)	1.9	3.6	4.2	0.9	7.1	5.4
Current account balance (EUR million)	354	280	2,789	-626	-1,296	-
Current account balance (% of GDP)	0.8	0.7	23.7	-5.8	-13.2	-
Gross foreign direct investment (EUR million)	766	2,899	410	75	393	-
Foreign exchange reserves (EUR million, eop)	12,908	12,688	12,116	12,688	14,158	13,734
Foreign debt (EUR million, eop)	45,958	46,664	46,512	46,664	49,230	-
<b>GOVERNMENT FINANCE*</b>						
Revenue (HRK million)**	125,879	131,917	34,692	33,179	32,342	-
Expense (HRK million)**	138,217	139,532	33,120	36,860	36,312	-
Net = Gross operating balance (HRK million)**	-12,339	-7,615	1,572	-3,681	-3,970	-
Net acquisition of non-financial assets (HRK million)**	5,264	4,855	1,033	1,951	829	-
Net lending/borrowing (HRK million)**	-17,603	-12,470	539	-5,632	-4,799	-
Domestic government debt (EUR million, eop)	20,458	21,630	20,452	21,630	21,889	-
Foreign government debt (EUR million, eop)	14,387	14,861	14,957	14,861	15,847	-
Total government debt (eop, % of GDP)	84,1	88,6	-	-	-	-
<b>MONETARY INDICATORS</b>						
Narrow money, M1 (% change, yoy, eop)	11.5	9.6	9.9	9.6	8.3	11.6
Broad money, M4 (% change, yoy, eop)	4.0	3.2	3.2	3.2	2.8	4.8
Total domestic credit (% change, yoy, eop)	0.9	-2.3	-5.2	-2.3	-0.6	-0.7
DMBs credit to households (% change, yoy, eop)	-1.8	-0.8	-1.5	-0.8	0.9	0.9
DMBs credit to enterprises (% change, yoy, eop)	-1.0	-3.7	-6.3	-3.7	-2.3	-2.6
Money market interest rate (% pa)	0.6	0.5	0.4	0.5	0.5	0.4
DMBs credit rate for enterprises, short-term, (% pa)***	6.4	5.9	5.9	5.7	5.6	5.6
DMBs credit rate for households, short-term, (% pa)***	7.6	7.4	7.3	7.3	7.3	7.2

**Notes:** \* Data refer to consolidated general government. \*\* On the cash principle. \*\*\* The weighted average interest rate on new loan agreements, revised data.

**Conventional abbreviations:** pa - period average, eop - end of period, yoy - year on year, HRK - Croatian kuna, EUR - euro, US\$ - U.S. dollar, DMB - deposit money bank.

**Sources:** Croatian Bureau of Statistics, Croatian National Bank and Ministry of Finance.

## Analyses

### On the road to market economy

After almost 25 years of transition, there is still a gap between newly enforced capitalist legislation and its institutional implementation. This process of implementation has somewhere been fast, and somewhere slow, and evidence seems to suggest that countries with accelerated reforms were rewarded with faster growth.

#### Product market regulation

This transition to capitalism that includes different structural reforms, liberalization and privatization is rather difficult to measure as it captures a vast part of the economy and society. The most straightforward way would be to measure the remaining power of the state, a residue from the time before the nineties. One way would be to measure the level of market regulation and the impact it has on entrepreneurship, trade and investment. As of 1998 the OECD has been trying to do just that by developing an indicator for the regulatory state of a country – the product market regulation indicator. The product market regulation indicator was not intended to simply present the regulatory state but also to inspect reform progress over time in OECD and later on in non-OECD countries as well.

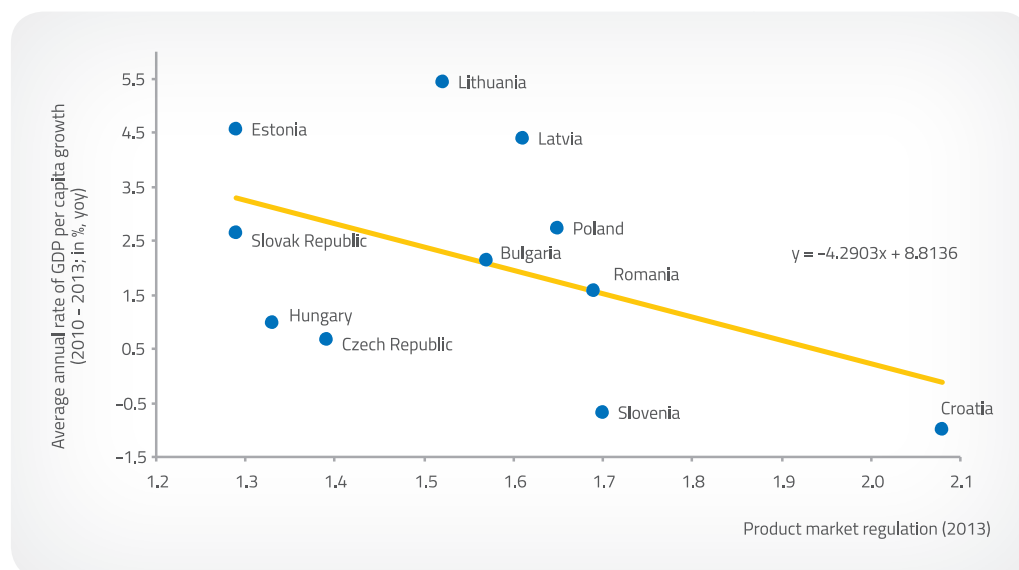
The latest update of the product market regulation indicator is available as of recently and it corresponds to the regulatory state of the countries examined in 2013. For the first time, OECD included Croatia into the study so we can inspect the level of market regulation in Croatia with respect to OECD and peer countries. The index itself is composed of an economy-wide product market regulation indicator, divided into different subcategories – state control, barriers to entrepreneurship, and barriers to trade and investment. The report also comprises a set of regulation indicators that cover seven network and five services sectors.

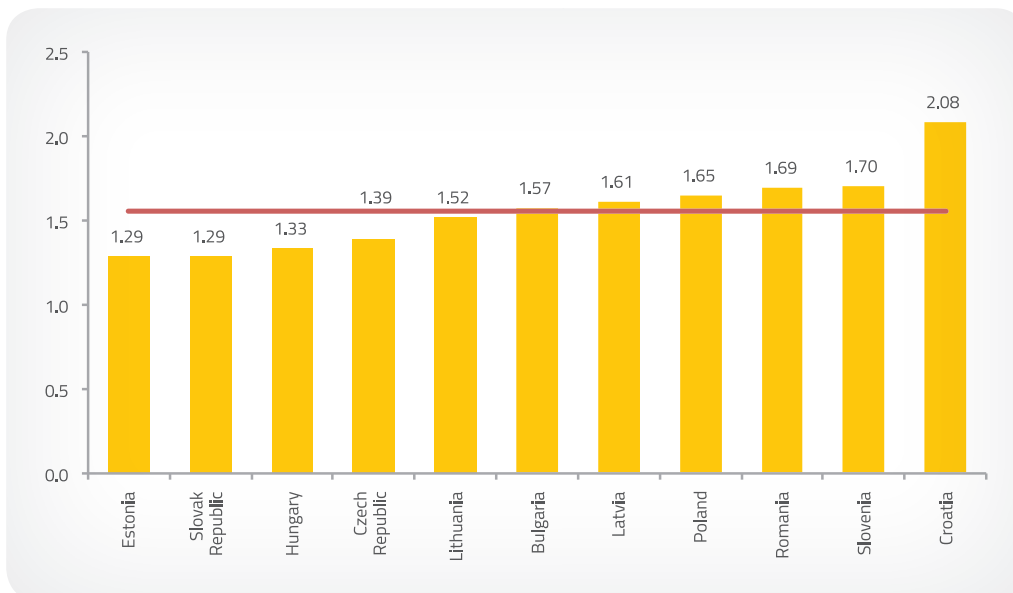
#### Accelerated reforms – faster growth

According to Wölfl et al. less restrictive product market regulation (lower index of product market regulation) favors economic growth (Wölfl, Anita, Giuseppe Nicoletti, Oliver Röhn and Isabelle Wanner, 2010, "Product Market Regulation: Extending the Analysis Beyond OECD Countries", OECD Economics Department Working Papers, No. 799, Paris: OECD Publishing). In their paper, the results of an empirical investigation suggest that the index of barriers to entrepreneurship that is half a point lower leads to approximately 0.4 percent higher average annual rate of GDP per capita growth. Although their research focused only on OECD countries, a simple

**Figure 8**  
Product Market Regulation and GDP per Capita

Source: Eurostat, OECD.





**Figure 9**  
Product Market  
Regulation (2013)

**Note:** Red line represents the average of peer countries.

**Source:** OECD.

scatter plot (Figure 8) showing Central and South East European countries implies a similar conclusion. The figure presents product market regulation indicator on the x-axis and after-crisis (2010-2013) average annual rate of GDP per capita growth on the y-axis. The linear trend line suggests a negative trend – higher product market regulation leads to lower growth of GDP per capita. Croatia stands far to the south-east of the graph suggesting that its market regulation is the highest among peer countries, amounting to 2.08 points (Figure 9), and that in the post-crisis period from 2010 to 2013 it depicted lowest GDP per capita growth, a fall in economic standard amounting to as much as -1.0 percent.

Although of course any further conclusions and policy suggestions from this simple presentation should be taken with caution, we would probably not make a big mistake stating that a decrease in product market regulation in Croatia could help the growth of GDP per capita. Inference such as this has already been confirmed in many research studies and the work done by OECD and the World Bank supports findings like this.

Naturally, we ask ourselves what stands behind the relatively high market regulation in Croatia. The first level of revelation is offered by the OECD product market regulation

indicator, that we will explore here in detail. This examination will not give us solutions to the causes of poor regulation but only shed light on the specific parts of regulation that need reform. The second layer of reasoning is much more complex and has a lot more to do with the communist heritage, politics, corporate governance, and culture. This layer will not be explored here.

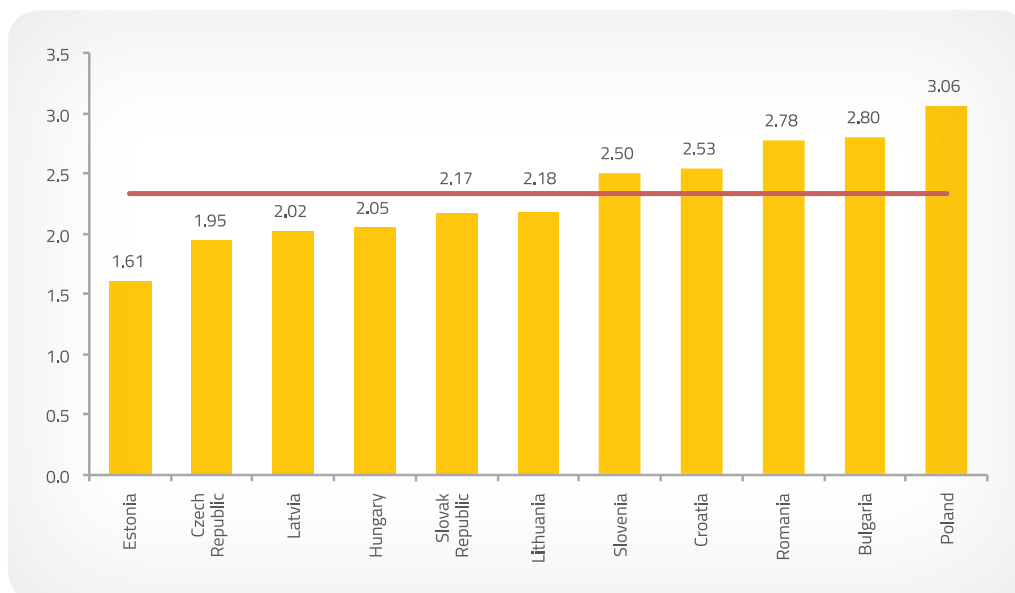
### State control, entrepreneurship, trade, and investment

Koske et al. bring up 18 different subcategories for which there is documentation on the level of product market regulation in Central and South East European countries (Koske, Isabell, Omar Barbiero, Rosamaria Bitetti and Isabelle Wanner, 2015, “The 2013 Update of the OECD’s Database on Product Market Regulation: Policy Insights for OECD and Non-OECD Countries”, OECD Economics Department Working Papers, No. 1200, Paris: OECD Publishing). First six subcategories fall under the category of state control – public ownership and state involvement in business operations. Following eight subcategories lie in the domain of barriers to entrepreneurship – complexity of regulatory procedures, administrative burdens on start-ups and regulatory protection of incumbents. The last four subcategories refer to barriers to trade and investment.

**Figure 10**  
State Control  
(2013)

**Note:** Red line represents the average of peer countries.

**Source:** OECD.



### Government uses coercive regulation

With a score of 2.53, state control in Croatia ranked eighth out of 11 countries explored (Figure 10). Its level of state control is slightly worse than the average of the countries in the group. Decomposition suggests that the strongest regulation can be found in the scope of state-owned enterprises (SOEs) that represent state control across 30 business sectors. Government stakes in the largest firms in network sectors (such as electricity, gas, rail transport, air transport, postal services and telecommunication) are also highly present in Croatia. The third big contributor to high regulation regarding state control is command and control regulation,

or the extent to which the government uses coercive regulation such as coercive monopoly, minimum wage laws, etc.

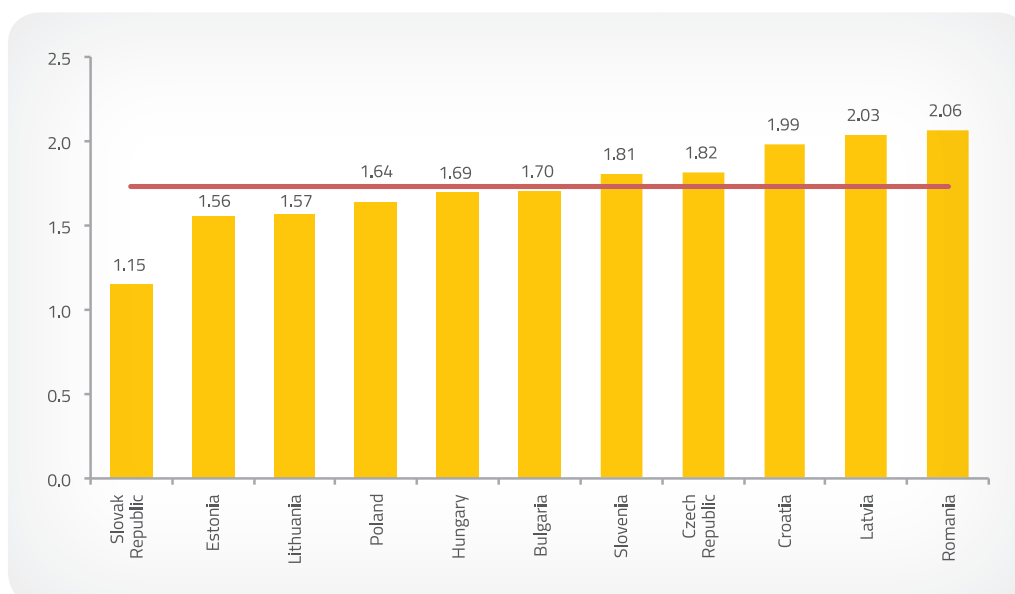
### Extremely high administrative burdens on start-ups

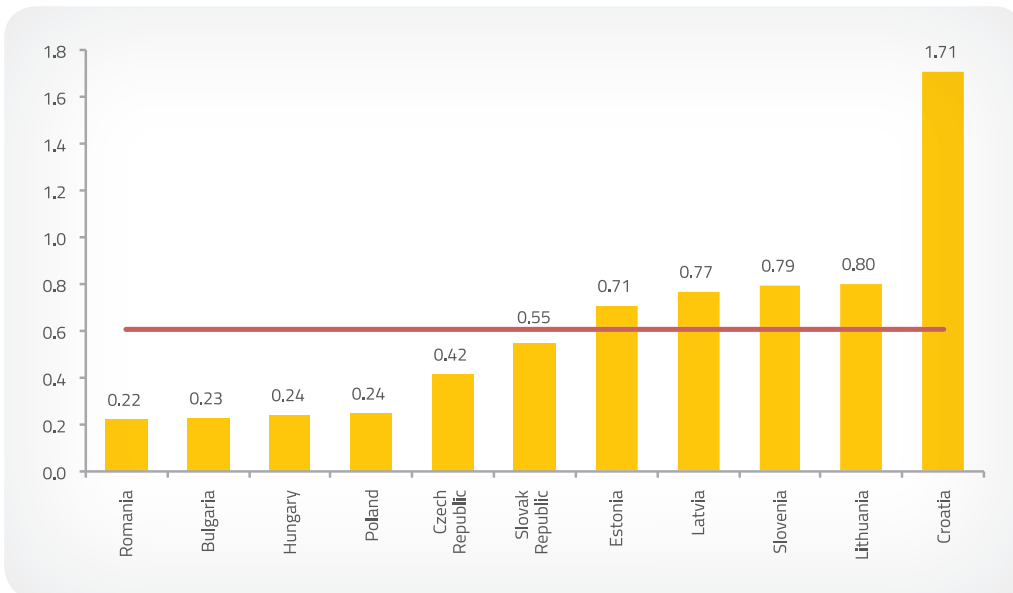
Croatia has relatively high barriers to entrepreneurship as its score of 1.99 ranks ninth out of 11 countries under investigation (Figure 11). Administrative burdens on start-ups seem to be the main culprits behind poor entrepreneurial climate. Specifically, administrative burdens on creating a public limited company or on creating an individual enterprise seem to be unusually high as Croatia ranks last or second last in these two subcategories.

**Figure 11**  
Barriers to  
Entrepreneurship  
(2013)

**Note:** Red line represents the average of peer countries.

**Source:** OECD.





**Figure 12**  
Barriers to Trade and Investment (2013)

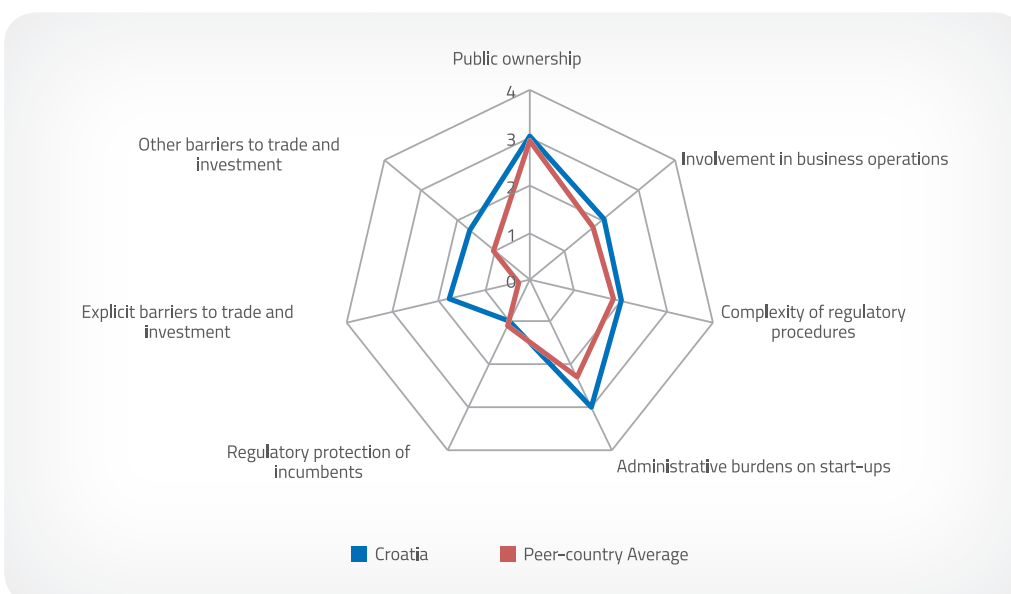
**Note:** Red line represents the average of peer countries.

**Source:** OECD.

### Croatia ranks last in barriers to FDI

However, the biggest divergence of Croatia from its peers is found in the category of barriers to trade and investment where Croatia ranks last and its indicator of 1.71 is more than twice as big as the second-last Lithuania (Figure 12). The biggest contributors to overregulation or restrictiveness in this category are barriers to FDI, related mostly to screening or approval mechanisms. In this subcategory Croatia ranks last, and it ranks second last in barriers to trade facilitation that concerns the use of international standards and international transparency of domestic regulation.

A quick look at Figure 13 reveals that Croatia has better regulation when compared to its peers only in the regulatory protection of incumbents, especially concerning antitrust exemptions (scope of exemptions from competition law for public enterprises) and entry barriers in network sectors. Public ownership regulation is about average, but the seemingly favorable result is highly influenced by direct control over enterprises (defined as the existence of special voting rights by the government in privately-owned firms and constraints to the sale of government stakes in publicly-controlled firms). The indicator for involvement in business operations in SOEs is not far from average owing to price controls



**Figure 13**  
Subcategories of Product Market Regulation (2013)

**Source:** OECD.

that are not that common in Croatia, but the level of command and control regulation is worrying as the government often uses coercive regulation, instead of incentive-based regulation. In that subcategory, Croatia and Slovenia rank the last in the group. Complexity of regulatory procedures with respect to entrepreneurship is also very close to the average of peer countries, and this time Slovenia and Croatia have top rankings and the best possible indicator of 0 in the subcategory that corresponds to government's communication and simplification of rules and procedures.

### Croatia and Slovenia comparable to Brazil, Turkey, Mexico and South Africa

In three other categories Croatia lags behind considerably. These are administrative burdens on start-ups, and both explicit and other barriers to trade and investment. Croatia's ranking in administrative burdens on start-ups is last with the indicator of 2.98 that corresponds approximately to the level of regulation found in Brazil or Turkey. In order to reach the average of peer countries this indicator of regulation should be improved to at least 2.30. In both explicit and other barriers to trade and investment Croatia ranks last with indicators amounting to 1.75 and 1.66 respectively. Such indicator levels for explicit barriers to trade and investment are somewhere in-between indicators found

in Russia and India. For the case of other barriers to trade and investment Croatia can be compared to Mexico, Slovenia or to South Africa.

### Big number of procedures and high costs to register a start-up

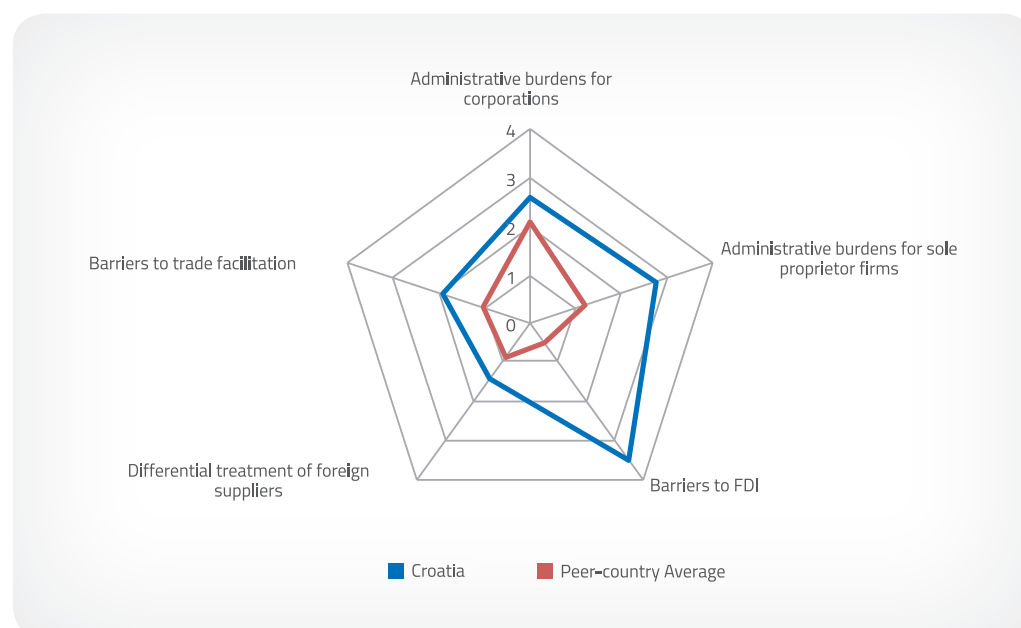
Figure 14 presents only five subcategories, out of possible 18, in which Croatia has taken one of the last three places on the peer ranking table. In these subcategories the level of divergence from the average is most pronounced, implying that regulation in these categories should be improved the most. Looking into the detailed results from OECD one can decipher specific topics that add the most to such poor results.

First, administrative burdens for corporations are troubled mostly by a big number of procedures that the entrepreneur has to complete in the pre-registration and registration stage of the start-up process. For Croatia that number is 18, while for example in Bulgaria it is only 7. Besides, Croatia has one of the highest typical total costs to complete all mandatory procedures to register a public limited company (pre-registration stage and registration stage combined) and one of the highest mandatory minimum paid-up capital needed to register a business.

Administrative burdens for sole proprietor firms are mostly the same as for corporations.

**Figure 14**  
Subcategories in Which Croatia Diverges the Most from Peer Countries (2013)

Source: OECD.



The entrepreneur has to complete 15 procedures in the pre-registration and registration stage of the start-up process as opposed to only three in most peer countries. Also, the cost of completing all mandatory procedures to register a public limited company and the cost of mandatory minimum paid-up capital needed to register a business are among the highest in the group of countries.

Regarding differential treatment to foreign suppliers in Croatia the number of foreign professionals permitted to practice legal profession is restricted by quotas, while cabotage on road transport is still limited. Barriers to trade facilitation improved when

Croatia joined the EU, but specific provisions which require or encourage regulators to use internationally harmonized standards and certification procedures are rare.

### Slow reforms, poor GDP growth

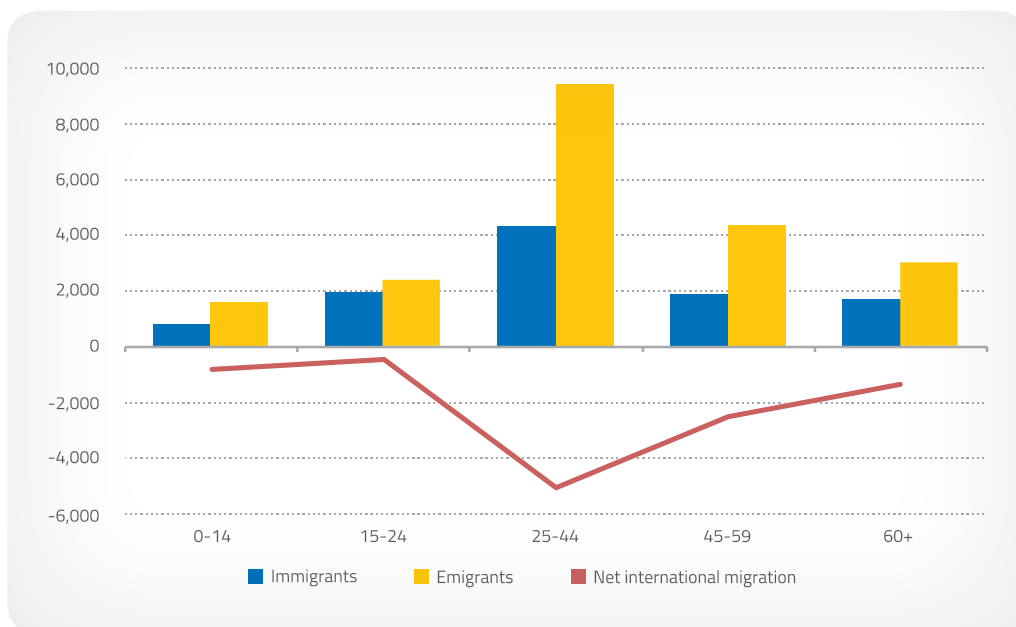
Having in mind the disappointing level of product market regulation in Croatia it is not hard to understand why Croatia has been lagging behind peer countries in recovering from the crisis. Reforms are slow in Croatia, and so is GDP growth recovery. Addressing institutions and necessary changes therefore seems to be the key to removing barriers to entrepreneurship and investment, and consequently boosting economic growth.

## Primed to leave

### Emigration - a threat to long-term growth prospects in Croatia

In line with negative economic developments, ever since 2009 Croatia is facing negative international migration balance. According to the Report from the Croatian Bureau of Statistics, almost 21 thousand people emigrated from Croatia in 2014 only, whereas more than 81 thousand people moved out of Croatia as of 2009. At the same time, less

than 52 thousand people officially moved into Croatia, contributing to a negative international migration balance of almost 30 thousand people in the period 2009-2014 and more than 10 thousand in 2014. Out of 20.9 thousand people that emigrated in 2014, 60 percent of them moved to EU countries, with Germany on top (38.0 percent), followed by Austria (9.6 percent). 45 percent of all emigrants in 2014 were in their prime age (25-44), while 56 percent were males (Figure 15).



**Figure 15**  
Net International Migration in 2014 by Age Groups

**Source:** Croatian Bureau of Statistics.

Although these trends could actually decrease the unemployment rate in the short term – by reducing the pool of unemployed and, consequently, the active population – if continued they could endanger long-term growth prospects in Croatia.

It seems that emigration is the key factor to understanding current labor market dynamics in Croatia. Additional efforts should be made

in exploring the power of these flows and their impact on the economy. First of all, figures presented here originate from the only source available and that is the Ministry of Interior Affairs (MIA). One should have in mind however that MIA's database undervalues true migration flows, especially emigration as people rarely deregister when they leave the country.

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