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Research Briefing
Emerging markets

Croatia facing challenges on the EU's doorstep

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Croatia's membership: A success for Croatia and the EU. Croatia will join the European Union on July 1, 2013 as its 28th member. It will be the second ex-Yugoslav state to become an EU member after Slovenia, which joined in 2004. Germany was the last EU country to ratify Croatia's accession treaty in May, clearing its way into the EU. Both from the Croatian and the EU perspective, the accession process has been a success. Croatia has made great strides regarding its political and economic integration into Europe, providing a template for the rest of the Western Balkans. From the EU perspective, the accession confirms that the European ideal is alive and that joining the EU is still attractive, despite the current woes in the eurozone.

Weak economic standing on the eve of EU entry. The combination of an unfavourable external environment and subdued domestic demand has taken a toll on the Croatian economy. Due to its strong trade and financial links, Croatia has been heavily exposed to the eurozone crisis. Croatia is one of the few countries where real GDP has not grown at all since the beginning of the global financial crisis. This has worsened the fiscal picture, with public debt approaching 60% of GDP.

Substantial medium-term benefits of EU entry but structural problems need to be solved first. In the medium term, full access to the single market, increased investor confidence and stronger financial integration should boost the economy – provided that Croatia manages to implement overdue structural reforms, in particular tackling a rigid labour market, an overblown public sector and a weak business climate. This means that short-term gains from accession will be few and far between.

Euro adoption not before the end of the decade. By entering the EU, Croatia implicitly agrees to also adopt the euro in the future. However, previous EU enlargement rounds in 2004 and 2007 have shown that it usually takes new member states several years until euro adoption. Currently, Croatia only satisfies one of the five Maastricht criteria in full. Especially in light of the fiscal challenges, it is highly unlikely that Croatia will join the eurozone before 2020.

Croatia

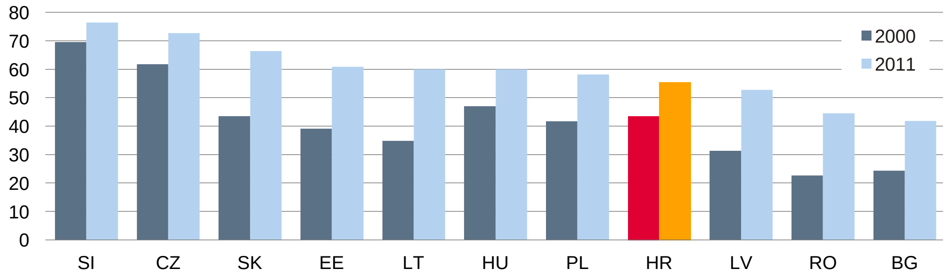
Capital	Zagreb
Population (m)	4.4
GDP per capita (EUR)	9,839
Currency	kuna

	2012	2013F	2014F
GDP (real, % yoy)	-2.0	-0.7	1.2
Inflation (% yoy, aop)	3.4	3.0	2.5
Current account (% GDP)	-0.1	0.0	-0.5
Fiscal balance (% GDP)	-3.8	-4.3	-4.0
Public debt (% GDP)	53.7	58.0	62.0

Sources: IMF, EC, national authorities, DB Research

Income convergence in the EU 1

GDP per capita (PPS), index (EU15=100)

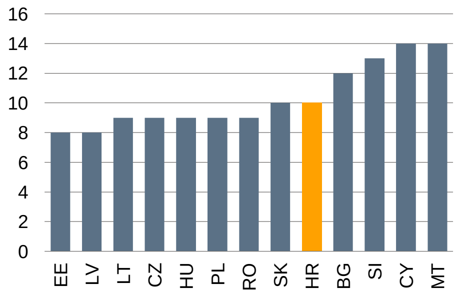


Note: EU15 are AT, BE, DK, FI, FR, DE, GR, IE, IT, LU, NL, PT, ES, SW, GB; PPS: purchasing power standard

Sources: Eurostat, DB Research

Application time in the EU mid-range 2

Years from EU application to accession

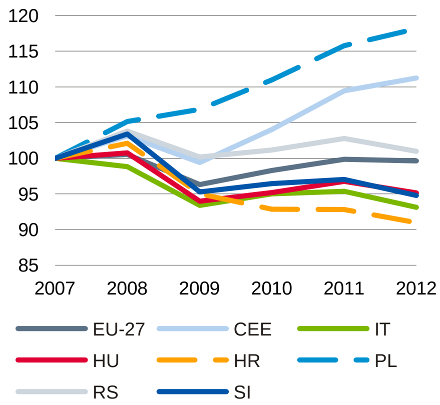


Note: all new member states joined the EU in 2004 (except for Bulgaria and Romania in 2007, Croatia in July 2013)

Sources: EC, DB Research

Strongly hit by the crisis 3

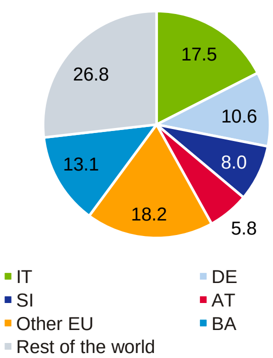
Real GDP, index (2007=100)



Sources: IMF, DB Research

Exports to the EU dominate 4

% of total (average 2008-12)



Sources: IMF, DB Research

Croatia's course into the EU

Croatia will join the European Union on July 1, 2013 as its 28th member. It will be the second ex-Yugoslav state to become an EU member after Slovenia, which joined in 2004. The European Commission's last monitoring report in March 2013 confirmed that Croatia had fulfilled the remaining conditions on competition policy, the judiciary and fundamental rights as well as justice, freedom and security.

The last real obstacle to Croatia's accession was overcome at the beginning of April when Slovenia ratified Croatia's EU accession treaty. A decade-long dispute between the two countries over Ljubljanska Banka going back to the partitioning of the former Yugoslavia had finally been settled. A border dispute between the neighbouring countries had already halted accession negotiations in 2008/9 for one year. Finally, with the approval of the accession treaty by the German Bundestag on May 16, the last formal hurdle for Croatia's EU accession was removed. Germany was the last of the 27 current EU member countries to ratify the treaty.

Croatia had already applied for EU membership in 2003 and started accession negotiations in 2005. This ten-year period between application and accession matches the average time it took for the 12 new member countries that joined the EU in the enlargement rounds of 2004 and 2007 (see chart 2). The fastest to accede were Estonia and Latvia at around eight years and the slowest, Cyprus and Malta at 14 years.

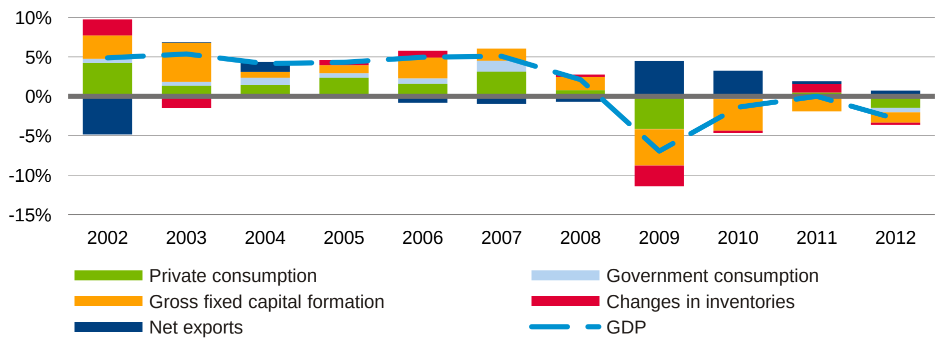
Whereas the EU enlargement rounds of 2004 and 2007 considerably changed the European Union's profile, Croatia's accession will only have marginal effects. Croatia will be the 9th smallest country in the EU by GDP size at 0.34% of the total. Its population of 4.4 million will account for 0.87% (8th smallest). Its GDP per capita (in PPS) in 2011 amounted to 61% of the EU27 average (55% of EU15, see chart 1).

Economic headwinds cloud EU entry

Croatia's integration into the EU and its institutions is a huge step for the Western Balkan country that endured more than four years of war before gaining independence from former Yugoslavia in 1995. Croatia's economy will – at least in the medium term – benefit from full access to EU markets and net revenues from the EU budget.

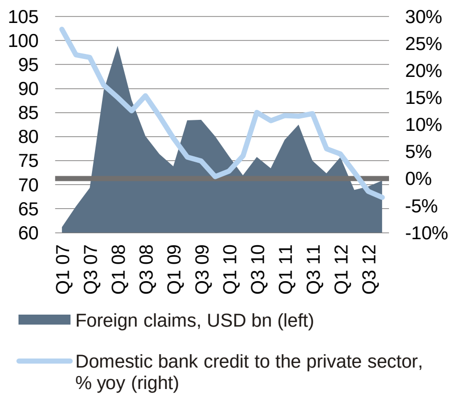
Drop in domestic demand weighs on economic growth 5

% yoy



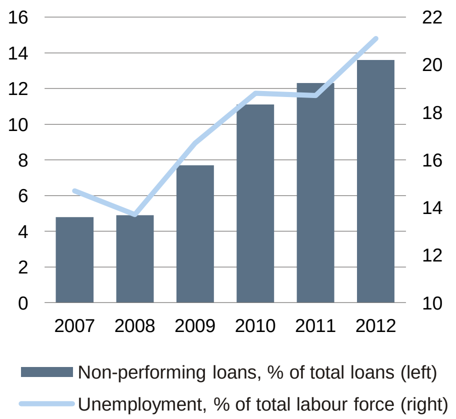
Sources: IMF DOTS, DB Research

Dry-out of foreign funds and lending 6



Sources: BIS, IMF, DB Research

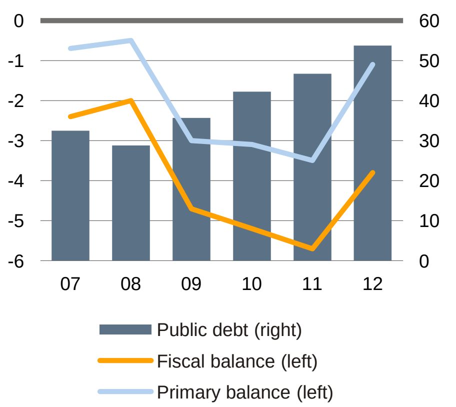
Tight credit conditions, high unemployment affect demand 7



Sources: IMF IFS, Croatian Bureau of Statistics, DB Research

Weak public finances 8

% of GDP



Sources: EC, DB Research

However, the short-term economic outlook is bleak. A combination of an unfavourable external environment as well as subdued domestic demand have taken a serious toll on the Croatian economy. The credit-driven economic boom of the years preceding the global financial crisis turned into a bust when foreign financial flows declined sharply. Croatia is one of the few countries which have not seen any year of positive GDP growth since 2008 (see chart 3). From 2008 to 2012, the economy shrank by a whopping 11%. Real GDP dipped back into recession in 2012, after zero growth in 2011. Also for 2013 we expect a recession, before the economy will gradually recover in 2014.

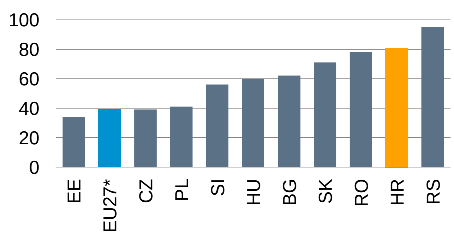
Croatia has been heavily exposed to the eurozone debt crisis, with about 60% of exports going to the currency bloc and almost 20% to Italy alone (see chart 4). The banking sector is foreign-dominated, with Italian parent banks holding almost half of the total assets. The Croatian currency, the kuna, is informally pegged to the euro. With around 70% of loans and above 60% of deposits denominated in or linked to foreign currency (EIU, 2013), the central bank is strongly committed to the peg, which limits the authorities' scope to react to the crisis via monetary and FX rate policies. The slowdown in export growth, foreign investment and credit has permeated the Croatian economy (see charts 5 and 6). Non-performing loans (NPLs) stood above 14% of total loans in March 2013. Unemployment increased by more than 7pp from the beginning of the financial crisis in 2007/8 to 20.9% of the labour force in April 2013 (see chart 7). Youth unemployment is estimated at above 40%.

For an emerging economy, public debt is high at close to 60% of GDP and is predicted to increase further over the next few years, given a fiscal deficit of above 3% of GDP and subdued economic growth prospects compared with the pre-crisis years (see chart 8). The combination of low growth, structural imbalances and weak public and external finances led to a downgrade of Croatia's sovereign rating below investment grade by two of the three major rating agencies, increasing the country's external refinancing costs. Nevertheless, Croatia has managed to avoid an IMF programme so far.

Beside the damaging impact of the eurozone crisis, structural problems lie at the root of Croatia's economic woes. These include a low diversification of Croatia's exports, which mainly rely on shipyards as well as tourism, two strongly pro-cyclical sectors. The international competitiveness of Croatia's economy is low, reflecting in particular rigidities in the labour market, an overblown public sector, and a weak business climate. This is reflected in low rankings in the World Bank's Doing Business (DB) and the Global Competitive Index (GCI) compared with peers (see charts 9 and 10). Among the Doing Business indicators, scores for "construction permits" and "protection of investors" are particularly low. Labour costs are relatively high compared to productivity.[1] According to the European Commission, the shadow economy could account for up to 40% of

Global Competitiveness Index 9

Ranking out of 144 (2012-13)

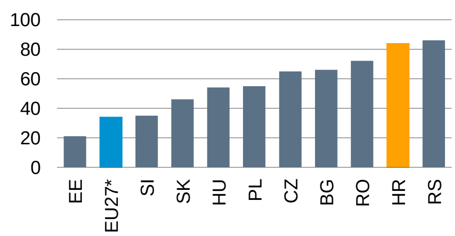


* EU27: median

Sources: World Economic Forum, DB Research

Ease of Doing Business 10

Ranking out of 184 (2013)



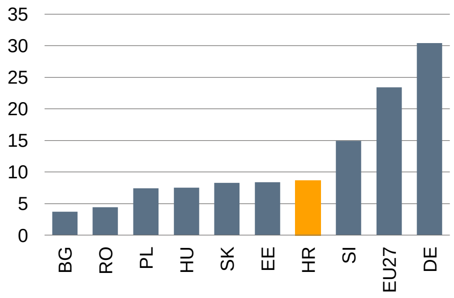
* EU27: median

Sources: World Bank, DB Research

[1] See IMF (2012): "The Republic of Croatia: Staff Report for the 2012 Article IV Consultation"; page 13f.

Relatively high wages 11

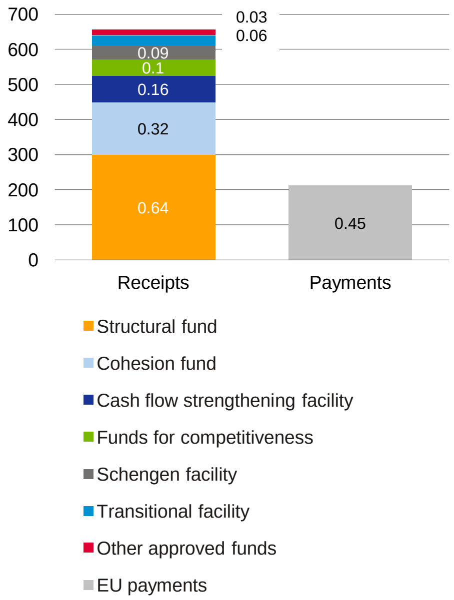
Wages, EUR per hour



Sources: Eurostat, DB Research

Croatia's financial EU benefits in 2013 12

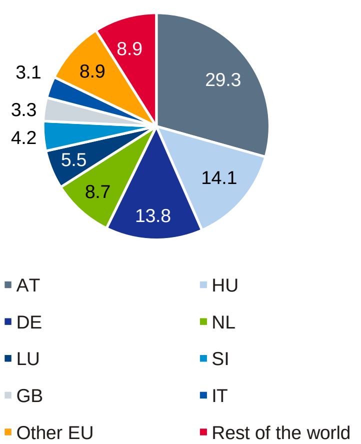
EUR m, % of GDP



Sources: European Commission, DB Research

Inward FDI largely from EU 13

% of total (2011)



Sources: IMF Coordinated Direct Investment Survey, DB Research

GDP.[2] While the government has started to address several of these issues in recent years, more and faster progress is necessary in particular regarding the inflexible labour market, privatisation of state-owned enterprises, reforms of the pension system and strengthening the business/investment climate.

Benefits of EU integration

As mentioned above, further structural reforms would be necessary for Croatia to reap the fruits of economic and institutional integration into the EU. But some of the financial advantages of EU membership will materialise quite soon. Upon accession, Croatia will, for example, gain access to the Cohesion Fund, the Structural Fund and the European Fisheries Fund. The total sum of approved funds for Croatia amounts to EUR 655 m (around 1.5% of GDP) for the second half of 2013 (see chart 12).[3] As a new member, Croatia will also receive funds from the Transitional Facility (EUR 29 m in 2013) in order to speed and smooth the journey from non-member to member as well as from the Cash Flow Strengthening Facility (EUR 75 m in 2013). The fact that Croatia will share its border with non-EU countries means that it will receive another EUR 40 m in 2013 in order to prepare its border for future entry into the Schengen area. On the other hand, Croatia will contribute an estimated EUR 212 m to the EU this year. The net receipts thus amount to 1% of GDP in 2013. Given that the EU's Multiannual Financial Framework (MFF) still needs to be approved by the European Parliament, estimates of receipts for 2014-2020 are only vague. But in the latest draft, total funds earmarked for Croatia were around EUR 13.7 bn.[4] Croatia's payments will be much lower, by comparison, and are currently approximated by around EUR 4 bn. Thus, net receipts would amount to EUR 1.39 bn on average per year (2.7% of 2013 forecasted GDP). This is comparable to the net receipts of Lithuania and Slovakia.

Croatia's economic success prior to the crisis was quite dependent on capital inflows, with net FDI covering a large share of the current account deficit in 2003-07, and abundant cross-border bank lending on top of that (see charts 6, 13 and 14). But capital inflows to the CEE region declined sharply when the global financial crisis erupted, and have remained subdued since. Moreover, investors and foreign parent banks have become more discriminating within the region, focusing more on key markets that are considered economically sound and profitable. Given the ongoing deleveraging in the banking industry in Western Europe as well as regulatory changes, foreign bank lending in Croatia is unlikely to pick up to pre-crisis levels over the next few years. That is why Croatia will need to rely even more on foreign direct investment. Croatia's EU membership is an important factor in this respect, helping to bolster investor confidence. According to the German Chamber of Commerce's Economic Survey for CEE 2012, EU membership remains one of the key factors that determine the attractiveness of CEE countries amongst investors.[5]

Overall, Croatia can be expected to profit considerably from its EU accession, not only politically but also in economic terms. Being part of an economic union, however, is also linked to new challenges. By entering the EU, Croatia becomes subject to the EU's Excessive Deficit Procedure (EDP) which is triggered once a member state exceeds the 3% of GDP deficit and 60% of GDP public debt ceilings defined in the Stability and Growth Pact. Possible sanctions include lifting the suspension of commitments from the EU's Cohesion Fund. Given Croatia's weak fiscal standing, it is more than likely that its EU entry will be accompanied by the EDP. However, both increased market competition and

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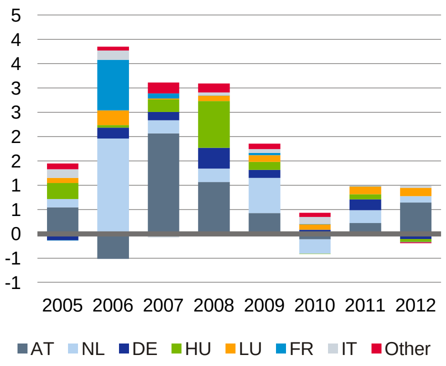
[2] European Commission (2013): "Assessment of the 2013 economic programme for Croatia".
[3] European Commission (2013): "2013 budget and MFF update to cover Croatia's entry to the EU".
[4] European Commission (2013): "Croatia and EU – prejudices and realities".
[5] AHK (2012): AHK-Konjunkturumfrage MOE 2012.

Strong drop in FDI inflows since the global crisis 14

EUR bn, by origin



Sources: Croatian Ministry of Finance, DB Research

Croatia and the euro 16

Criterion	Latest reference*	Croatia
Inflation	2.6%	3.9%
Interest rate	5.4%	5.5%
Exchange rate	ERM II	no
Public debt	60%	53.7
Public deficit	3%	3.8%

*Partly own calculations, May 2013 data
Sources: EC, Eurostat, Datastream, DB Research

Country key 17

Austria	AT
Bosnia and Herzegovina	BA
Bulgaria	BG
Croatia	HR
Czech Republic	CZ
Estonia	EE
Germany	DE
Hungary	HU
Italy	IT
Latvia	LV
Lithuania	LT
Luxemburg	LU
Netherlands	NL
Poland	PL
Romania	RO
Serbia	RS
Slovakia	SK
Slovenia	SI
Sweden	SE
United Kingdom	GB

Source: DB Research

fiscal supervision, while at first potentially generating economic costs, should in the medium term help to boost competitiveness and fiscal discipline, thereby supporting more sustainable economic development.

Euro adoption not before the end of the decade

With its entry into the European Union, Croatia, like all EU member states[6], agrees to also join the euro. However, there is no predefined timeframe for adopting the euro, as it depends on the fulfilment of a list of convergence criteria laid down in the Maastricht Treaty (see table 15) and therefore not only on the economic conditions but also the political willingness to comply with the criteria and to adopt the euro. As demonstrated by previous EU enlargements in 2004 and 2007, it is likely to take several years until Croatia embarks on the final stage of European integration and eventually replaces its kuna with the euro.

Convergence criteria to join the euro area 15

As all EU countries that prepare themselves for joining the eurozone, also Croatia will also have to fulfil five Maastricht criteria that serve as preconditions for the single currency:

— The 12-month average of CPI must be at most 1.5 percentage points above the average of the three lowest CPI values in the EU.

— The long-term interest rate must be at most 2 percentage points above the average of the three lowest CPI values in the EU.

— Croatia has to join ERM II and keep its Euro exchange rate within +/- 15% of a central rate, which is not allowed to be changed, for two years.

— The government debt to GDP ratio must be at most 60%.

— The fiscal deficit must be at most 3% of GDP.

Source: European Commission

So far, 5 of the 12 new member states have joined the common currency. Slovenia was the fastest, with only three years from EU entry in 2004 to euro adoption in 2007. Cyprus and Malta joined the currency bloc in 2008, Slovakia in 2009, and Estonia in 2011. The EC and the ECB recently gave the go-ahead for Latvia to join in 2014 and Lithuania plans to follow in 2015 – even though in both countries polls suggest that euro adoption currently is not backed by a majority of the population. Poland, the Czech Republic, Hungary, Romania and Bulgaria have refrained from committing to a joining date.

Currently, Croatia only meets one of five criteria fully (see table 16). At 5.5% the 12-month average of the long-term interest rate in May is just above the allowed maximum. Even though the kuna/euro exchange rate has not fluctuated more than +/-15% around the two-year mean (7.51 HKR/EUR), Croatia still needs to officially join ERM II for a two-year period before it can adopt the euro. The inflation criterion was fulfilled in previous years but a recent hike in Croatia's price levels in late 2012 sent the inflation rate above the allowed range. Officially, government debt amounted to 53.7% of GDP in 2012, below the 60% Maastricht limit. However, against the background of current economic weaknesses and low revenues, public debt is expected to breach 60% of GDP next year. In addition, this measure does not include around 15% of publicly guaranteed debt, which would drive total debt even higher. The fiscal deficit has breached the 3% of GDP limit every year since 2009 and is expected to stay above the limit in the foreseeable future. All in all, euro adoption is unlikely to occur before 2020 at the earliest.

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[6] Exemptions are granted to the UK and Denmark.

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