Country Study
Croatia

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Croatia's economic prospects are promising. In recent years, it has enjoyed solid economic growth, a stable currency, and low inflation, and has made progress in fiscal consolidation. Croatia completed its final Stand-By Arrangement with the IMF in 2006, and negotiations for EU membership are well under way. Recent growth, however, has been above potential, and external vulnerabilities have emerged. Structural reforms have moved more slowly than in peer countries, and the role of the state is still significant in most aspects of economic activity. With the highest external debt-to-GDP ratio among transition countries, the Croatian economy is subject to exchange and interest rate risks. Recent IMF staff research on Croatia has focused on reforms to ensure macroeconomic stability, increase potential growth, and reduce external vulnerabilities.

Croatia has experienced solid growth in recent years, but IMF staff estimates indicate somewhat lower potential growth, which highlights the need for structural reforms. Real GDP growth averaged around 4¾ percent annually during 2001–05 and continued at 4.8 percent in 2006. Moore and Vamvakidis (2007) estimate Croatia's potential growth, however, at 4–4½ percent. This estimate is robust to different methodologies: estimation of a production function; simulation of a growth model for Croatia using estimates from a cross-country regression; and a growth diagnostic exercise. Increasing Croatia's potential growth will require significant productivity-enhancing reforms.

The results in the study highlight the critical need for structural reforms to improve the business environment by reducing the administrative burden, legal uncertainties, and corruption, and to reduce the role of the state in the economy by making faster progress on fiscal consolidation and privatization. The analysis indicates that despite recent steps in the right direction, Croatia's progress in structural reforms has been slower than in peer countries and needs to be accelerated to increase productivity and growth. In a similar vein, Konuki's (2004) analysis of Croatia's labor market performance—which has been poor, compared with other Central and Eastern European countries—indicates the need for reforms to relax Croatia's strict employment protection regulation to boost employment in the official sector, expand the tax base, and boost productivity.

One reason for the slow pace of structural reforms in Croatia, which is analyzed in Vamvakidis (2007), may be the ease of obtaining foreign financing. A political economy model and empirical evidence from a sample of emerging and transition economies suggest that external financing often acts as a "pain reliever" by postponing the needed treatment of a "sick" economy by economic reform. In Moore and Vamvakidis (2007), a simulation of the model for Croatia shows that the rapid rise in external debt may, indeed, have financed the status quo, contributing to delays in the overall reform process. The results suggest that policies to reduce Croatia's indebtedness could trigger broader reforms that would, in turn, contribute to faster economic growth.

Fiscal consolidation can have such an impact. Spending cuts and good revenue performance, which is due largely to faster-than-projected growth, reduced the general government deficit from 6.1 percent of GDP in 2003 to 3 percent of GDP in 2006. Croatia's general government still spends 49 percent of GDP, however, compared with an average of 40 percent for its regional peers. The vulnerabilities associated with Croatia's high current account deficit (7.6 percent of GDP in 2006) and external debt (85 percent of GDP in the same year) also call for fiscal tightening. Gueorguiev (2007) applies the IMF's Global Fiscal Model to show how a strategy of cutting expenditure and taxes—while also reducing the deficit—could stimulate investment and the labor supply, leading to higher output and consumption, and a lower current account deficit. According to the model simulations, the benefits of such a strategy increase at least proportionately with the degree of ambition in efforts to reduce public expenditure. A corporate income tax cut and cuts in social security contributions would also result in benefits—indeed, the simulations may understate the employment and competitiveness payoffs from lower social security contributions.

Balance-sheet analysis in Hilaire and Ilyina (2007) indicates that Croatia's external vulnerabilities have increased in recent years, in particular in the private nonfinancial sector. These vulnerabilities stem from both a rapid buildup of external debt, fueled mostly by private demand for credit, and deepening financial euroization. External debt as a per-

centage of GDP—whether gross, net, or short term—rose sharply between 2000 and 2005, while the debt-service burden has remained broadly stable, owing to low international interest rates in that period. Firms and households have accumulated large net liabilities that are sensitive to changes in exchange and interest rates, which has placed a premium on avoiding sharp exchange rate and interest rate movements but also restricted the scope for autonomous monetary policy.

Indeed, Čihák and Konuki (2004) show empirically that when there is a broadly stable kuna-euro exchange rate combined with a relatively open capital account, monetary policy in Croatia is ineffective for aggregate demand management, leaving fiscal policy as the main policy tool. Financial conditions in the economy are only weakly correlated with the monetary policy stance; and although monetary policy can exert limited control over money market interest rates, its influence on lending rates is uncertain and is felt with long lags. Despite recent prudential and administrative measures implemented by the central bank through the end of 2006—including a marginal reserve requirement on banks' foreign borrowings and a period of administrative controls—rapid credit growth has persisted. Banks have avoided the measures by expanding lending through nonbank channels or have chosen to pay the costs of these measures in order to capture market share. In Čihák (2004), evidence of falling interest rate spreads—particularly for foreign, large, and well-capitalized banks—is one of many indicators of the strong competition for market share in Croatia's banking sector.

In this context, strong prudential supervision is critical to counter an excessive buildup of banks' foreign currency exposures to unhedged clients. Rapid credit growth in recent years has raised banks' susceptibility to an economic downturn. Mitra (2007) estimates a simple model of credit risk and bank stability in a three-stage, least-squares framework for emerging markets in Europe. Simulations of the model for Croatia suggest that a slowdown in economic growth could have a large negative effect on bank capitalization by affecting borrowers' ability to service their loans. This means that banks should build buffers during good times, by either raising capital or making provisions for unidentified losses. The analysis also finds that Croatian banks are not necessarily passing on the higher risk of foreign exchange-linked loans to unhedged clients by charging higher interest rates, possibly owing to strong competition among the top banks. Thus, the possibility that the risk premium embedded in loan interest rates is too low reinforces the case for banks to build up provisions or raise capital.

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