

The background features abstract, colorful swirls in shades of green, purple, and blue, interspersed with small yellow triangles. The overall aesthetic is modern and dynamic.

Impact of the Global Financial Crisis on Croatia

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International Conference “Contemporary Problems in Corporate Governance”, held by the University of Gdansk, Faculty of Business Administration in Sopot on May 30-31, 2011.

Purpose and Structure of the Paper

Purpose:

- The Western Balkan economy was steadily developing since 2000 and was expected to continue its development. However, the global financial crisis, which was culminated by the Lehman Shock on September 15, 2008, crushed such an expectation. This paper considers reasons why their economies' vulnerability to external changes is so high, taking the case of Croatia as an example.

Structure of the paper:

- Characteristics of the Economies of the Western Balkans
- Impact of the Global Financial Crisis
- Croatian Economy after the Regime Change
- Chronic Current Account Deficit
- Economic Recovery Program
- Conclusion

Characteristics of the Economies of the Western Balkans

- Greatly dependent on the EU economy. A main foreign partner.
- Inward FDI flowed mostly into services, especially banking, telecommunications and real estate.
- Presence of foreign banks in the region is remarkable. Share of foreign-capital banks in total assets ranges from 75.3% to 95.0%.
- The use of foreign currencies (currency substitution) is prevalent in people's daily lives. Euro-ized economy

Impact of the Global Financial Crisis

- Impact of the global financial crisis came to this country indirectly (mainly through the EU countries) through three channels:
 1. A decline in external demands. Demand in the EU countries decreased, causing a decrease in Croatian exports to the EU markets.
 2. Tightened international financial market. Rollover of debts became much more difficult. Banks' lending interest rates increased. The Croatian National Bank cut banks' reserve requirement rate from 17% to 14% in December 2008 and cut it further to 13% in February in 2009, thereby releasing a portion of banks' funds allocated for this purpose. Nevertheless banks' lending to enterprises and households decelerated, resulting in a further decline in economic activities.
 3. A decrease in FDI inflows. The amount of FDI suddenly plummeted by nearly 70% in 2009, affecting the economy negatively.

Table 1 Changes in GDP in the Western Balkan and Other Countries

	2007	2008	2009	2010 (Forecast)	2011 (Forecast)
Croatia	5.5	2.4	-5.8	-1.3	2.0
Macedonia	5.9	4.8	-0.9	0.8	3.2
Albania	6.0	7.8	3.3	3.8	2.6
Bosnia and Herzegovina	6.2	6.0	-2.8	0.8	2.2
Montenegro	10.7	6.9	-5.7	0.2	3.1
Serbia	6.9	5.5	-3.1	2.0	3.0
Reference					
Hungary	1.0	0.8	-6.7	1.3	2.0
Estonia	7.2	-5.1	-13.9	2.4	3.6
Latvia	10.0	-4.2	-18.0	-0.1	2.7
Lithuania	9.8	2.9	-14.7	0.7	2.5

Source: For 2007 Astrov. M., et al (2010), p.59; For other years EBRD
(<http://www.ebrd.com>)

Extent of the Shock

- In 2009 the GDP growth rate is -5.8 percent in Croatia and -6.7 percent in Hungary. Compared with the GDP growth rate in 2008 the difference is bigger in Croatia (8.2%) than in Hungary (7.5%).
- In addition, the growth rate in 2010 is positive (0.8%), albeit slightly, in Hungary while it remains negative (-1.5%) in Croatia.
- Among 28 transition countries only 4 countries recorded (other than Croatia, Latvia, Romania and the Kyrgyz Republic) a negative GDP growth in 2010 (EBRD).
- It may be said that the situation is more serious in Croatia than in Hungary.

Changes in Industrial Structure and De-industrialization

- Since the regime change the industrial structure has substantially changed. Changes in the employment structure
- In 2005/6 GDP recovered its peak level in 1989 while the outputs of agriculture and manufacturing have regained only three fourths (76.7 % and 75.4 % respectively).
- In contrast, other activities, especially services have remarkably increased.
- 'Massive deindustrialization' has occurred (Jurcic and Vojnic, 2009, p.770).

Table 2 Changes in Employment Structure

	1998	2006
Agriculture, forestry and fishing	10.8	5.4
Industry total	24.6	22.3
Construction	7.0	8.9
Wholesale, retail trade, hotels, etc.	20.0	23.0
Transport and telecommunications	7.1	6.7
Other activities	30.6	33.7
Total	100	100

Sources: wiiw (2007), p.126.

Shipbuilding

- Third place in shipbuilding in the world during the period of former Yugoslavia (Horvat, 1999; *BCE*, May 2000).
- After 1990, however, the shipbuilding industry has been stagnating. Because it lost an important market like the COMECON countries and the shipyards were kept in state hands without enough investment and lost their competitiveness.
- Now Croatian shipbuilding has around 1.5 percent of the global market and is in fourth place in Europe.
- A very important industry which earns 5 % of GDP and it accounts for more than 11 % of total exports of the country. 12,000 workers, and a further 35,000 jobs are directly linked to the industry.
- Of six shipyards only one (Pula) is profitable. The remaining ones are loss-making and continue their operations under the support of the government's subsidy, which contravenes the EU's regulations.
- The government is inviting public tenders, but it is difficult to find buyers.

Inward FDI

- Financial intermediary has an overwhelmingly big share, and the amount of FDI inflow into manufacturing has been smaller.
- Greenfield investment has been negligible (only 16%).
- Although data is a little bit old (as of 2003), among manufacturing branches which attracted FDI the export-oriented branches are pharmaceuticals (Pliva), other non-metallic products (i.e. cement industry), food and beverages (Coca Cola), rubber and plastics and electrical and optical equipment (Siemens). The remaining branches are oriented toward domestic markets.
- Foreign investment enterprises account for only 16 % of the total Croatian export. The situation is quite different from Hungary, the Czech Republic and Poland where foreign investment enterprises have been the driving force behind their exports with the share of foreign investment enterprises in exports being 89%, 60% and 60% respectively.
- In Croatia, not accompanied by an improvement of competitiveness and an increase in exports.

External borrowings increased.

- While a part of the financial inflows was in the form of FDI, external borrowing increased rapidly with the intermediation by foreign-owned banks.
- Much of the external flows went into consumption and non-tradable sectors (construction, real estate, and wholesale and retail trade), feeding into higher imports (IMF, 2009, p. 6).

A Chronic Current Account Deficit

- Croatia has continuously recorded deficit in goods trade with the export/import ratio being around 50 %.
- Its trade balance deficit reached over 20 % of the GDP (21.2% in 2007 and 22.7% 2008).
- Breakdown of the trade balance: although a huge amount of deficit in goods trade has been substantially covered by surplus in service trade, the trade balance as a whole has recorded a deficit.
- The share of tourism has been predominantly big in the service trade, but tourism is vulnerable to changes in external environment.
- In this way, a huge amount of deficit in goods trade balance has been compensated mainly by revenues from travel (tourism) and current transfer. Still the country is recording considerable amount of current account deficit every year, with it reaching 9.2 % of GDP in 2008.

Table 3 Structure of Croatian Exports by Major Product Category, 1996 and 2005

	1996	2005
Share of total exports (%)		
Food and feed	11.4	10.5
Agricultural raw materials	4.7	3.4
Ores and metals	2.2	3.8
Fuels	9.2	13.9
Chemicals	14.1	9.8
Leather and rubber	2.3	1.7
Wood and papers	2.7	3.0
Textiles and clothing	16.5	7.7
Machinery excluding auto	20.0	27.0
Motor vehicles and parts	1.4	2.0
Miscellaneous manufacturing	15.4	17.0

Source: Kathuria (ed.) (2008), p.40.

Table 4 Gross Labor Cost in the Western Balkans

(All sectors, in Euros)

	2003	2004	2005
Albania	134	148	161
Croatia	740	794	841
Bosnia and Herzegovina	395	402	420
Macedonia	322	335	343
Montenegro	271	303	326
Serbia	255	281	307
Reference			
Bulgaria	142	150	161
Hungary	541	578	638
Poland	497	501	586

Source: Kathuria, S.(ed.) (2008), pp. 52-53.

A decline in the international competitiveness (1)

- Croatian manufacturing exports to the EU increased only moderately between 1995 and 2002 and Croatian market share on the EU market (excluding intra-EU trade) declined significantly, from 0.42 % to 0.29 % (Vidovic and Gligorov, 2004, p.30).
- This means that the international competitiveness of Croatian manufacturing has declined.
- Why has it declined gradually?

A decline in the int'l competitiveness (2)

Reasons:

- Due to insufficient investment in manufacturing its technology has been lagging behind that of other countries, especially East Asian countries.
- Due to ongoing globalization, products made in East Asian countries, especially China have been increasingly flowing into European markets. Products of all manufactures (from Chemicals to Miscellaneous manufacturing) account for about 70 % (72.4 % in 1996 and 68.2 % in 2005) of the total exports, but they incline heavily toward labor intensive industries. Textiles and clothing decreased its share considerably. Thus textile and clothing industries in Croatia have been chased by counterparts in China and other Asian countries with their lower wages as a weapon, and the Croatian industries have had to fight in a tough game in European markets.
- The exchange rate has been too high (Jurcic and Vojnic, 2009).

Tariff rates are already low.

- During the period 2001-2005 the tariff rate for all goods in Croatia decreased from 7.6% to 2.4% while the average rate in the Western Balkans decreased from 8.8% to 5.3% (Kathuria, 2008, p. 38).
- The tariff rates in Croatia have been the lowest among the countries of the Western Balkans and they have been as low as in developed industrial countries.
- If transition countries such as Croatia are not allowed to use tariff barriers to protect their own industries, then there seems to be no way for these countries other than to use exchange rate regimes.

An enigma about the exchange rate

- Although Croatia officially adopts managed floating, its exchange rate regime is, in fact, closer to Euro peg. Its exchange rate fluctuated between 7.3 HRK/EUR and 7.5 HRK/EUR during the observed period.
- Why the monetary authorities in Croatia stick to a high exchange rate of the Kuna ?
- Presumably because Croatian people have experienced hideous hyperinflation twice, first in 1989 during the period of the former Yugoslavia and second in 1993 after the independence, consequently giving stability of prices the first priority.
- Now Croatia as an EU Candidate aims to adopt euro in the near future. Croatian monetary authorities may have followed advice by the European Central Bank to keep present exchange rate.
- The Croatian economy is to a considerable extent euroized. Along with Kuna deposits, households as well as enterprises in Croatia have foreign currency deposits with banks (which are mostly foreign capital-owned) and at the same time borrow money in foreign currency (more accurately, Kuna indexed to euro; in recent years more often to Swiss Franc). Presumably, interests of Croatian people have been too entangled to accept depreciation of Kuna.

Severely indebted middle-income country

- Croatia's external deficit as percentage of GDP reached 85 % in the end of 2003, a level almost unsustainable.
- The report of the World Bank Development Finance 2005 degraded Croatia to a 'severely indebted middle-income country' from a 'moderately indebted middle-income country'.

*The World Bank criterion for a country being 'severely indebted' is that either the debt to GDP ratio is above 80 percent or that the ratio of debt to exports of goods and services is above 220 percent. Either condition is sufficient. The case of Croatia corresponds to the former. (Vidovic and Gligorov, 2006, p. 23).

- This ratio reached 98.5% in 2009. Thus, the economy was becoming more and more vulnerable to changes in the external environment.
- In such a situation the global financial crisis dealt this country a crucial blow.

Economic Recovery Program (1)

- The Program contains both short-term policy measures and mid and long-term policy measures. The Program emphasizes that while creating a stimulatory entrepreneurial environment by its activities the state can only promote economic development and that it cannot replace private initiatives and responsibilities, and appeals to the public, saying “we have to change our conception and habit.
- Croatia’ option is similar to the dilemma which Latvia faced in 2009. Instead of (external) devaluation of the national currency (Lat), Latvia has chosen ‘internal devaluation’, i.e. to curtail wages and pensions and decrease unit labor costs. In the same way, the Program for Economic Recovery proposes ‘internal devaluation’ without mentioning this term.

Economic Recovery Program (2)

- Fiscal policies are targeted at 1) Fiscal consolidation, 2) a gradual decrease of the share of the general government expenditures and revenues in GDP. More concretely, all special measures for the reduction of income tax shall be abolished except the fiscal stimulation for R&D. The government expenditures shall be decreased.
- The EU's regulation shall be consistently applied in respect of the vertical state support. cf. Shipbuilding industry.
- As for public administration, 1) rationalization of the public administration system and 2) improvement of efficiency in providing public services shall be pursued.
- The number of workers in the public sector shall be decreased by 5 % and the total payroll of workers in the public sector shall be decreased by 10 %.
- The government will prepare plans to privatize the remaining state-owned enterprises (big-scale enterprises such as Croatian Electric Power, Croatian Insurance, Croatian Railways, etc. are still in state hands).

Economic Recovery Program (3)

- As for revitalization of the economy, the state intervention in the economy shall be decreased. Starting businesses shall be encouraged. A new investment cycle with maximum participation of the private sector shall be started. Investment projects shall be stimulated with emphasis on i) energy (renewable energy is attached importance), ii) protection of environment, iii) education and health, iv) agriculture and irrigation, v) infrastructure.
- Projects shall be financed first of all by private capitals and financial resources from the EU funds, and smaller parts shall be financed through public enterprises.
- In order to promote the Croatian economy, the government will make efforts to promote technology transfer and improve competitiveness.
- The government has made efforts to attract foreign direct investment, but hereafter the government shall make more efforts to get rid of obstacles to investments and actively attract FDI.

Economic Recovery Program (4)

- As for the labor market, flexicurity, a term which is often discussed in Nordic countries, is used in this area. It is the concept that the labor market which has been rigid so far shall be made flexible (i.e., dismissal of workers shall become easier), but at the same time it shall be easier for dismissed workers to be employed in new jobs.
- An emphasis is put on the encouragement of unemployed people as well as the inactive category of the productive population to improve their ability and qualifications in order for them to be employed in a new area.
- The economic activity rate as well as the employment rate is rather lower compared with other countries. The government aims to increase these rates.

Conclusion (1)

- These countries attained economic development led by domestic consumption, relying on foreign capitals. Their method of economic development intensified vulnerability to external shocks. In such a situation the global financial crisis dealt these countries crucial blows.
- In Croatia its external debts amounted to nearly 100 percent of GDP in 2008. The economic development involving a huge amount of current account deficit was already unsustainable at that time.
- Croatia is now required to do a switchover of the existing model of economic development, i.e. domestic consumption exceeding domestic export, imports exceeding exports and investments exceeding savings.
- The country is required to enhance the export competitiveness of its manufacturing industry.

Conclusion (2)

- The Economic Recovery Program requires the Croatian people austerity for a while, but I wonder whether people can endure it.
- The Program also stresses the necessity for an increase in employment, production and exports. The problem is in which areas the employment should be increased.
- The program stresses that while decreasing state intervention in economic movement the government will encourage starting businesses and initiate a new investment cycle led by the private sector with long-term effects. --- Uneasy challenges
- It is to be seen whether such an attempt proves successful without enough state support.