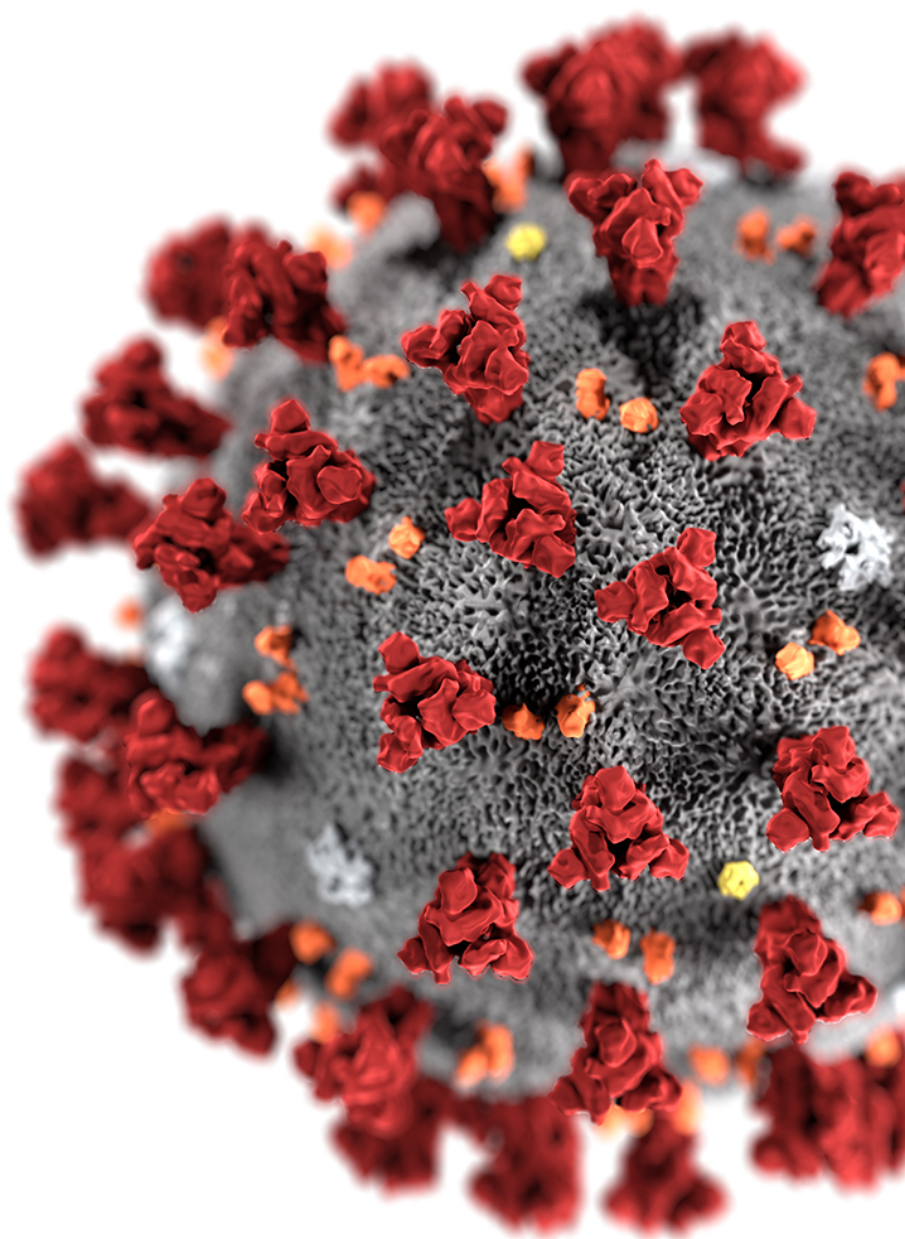




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Croatia: The economy in an Awkward Corner

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PROF. DR. DAMIR NOVOTNY, EDWARD BERNAYS UNIVERSITY COLLEGE OF
APPLIED SCIENCES, ZAGREB, CROATIA

Introduction

The unexpected rapid spread of coronaviruses to Europe and other developed countries, especially densely populated areas in Europe and the US, has caused unprecedented public health measures in recent history. Global mobility of people and goods and globalized economic activity has slowed sharply. Although the phenomenon of economic cycles has been known for over a hundred years and much knowledge of cyclical economic trends has been accumulated, after the epidemic has calmed down, we'll be faced with an economic crisis we have never seen before. Namely, the response of governments and central banks to the Great Crisis of 2008, which had its source in the US subprime housing market, was a strong fiscal and monetary intervention and the provision of liquidity to economic actors. Some European countries, such as Germany, have implemented austerity measures (which have had numerous opponents in other European countries), thus *producing so-called Keynesian effects by implementing (neo) classical economic policies*.

The economic crisis of 2008, except for Greece and Croatia, lasted relatively short. Most European economies quickly recovered and started with a new, strong cycle of economic growth that enabled the accumulation of capital in the private sector and the creation of budget surpluses in the public sector. This created the reserves and the capacity for fiscal intervention in the case of the new economic crisis, which would surely have happened without the shock caused by the spread of the coronavirus. Let us take the example of the Hellenic Republic. Thanks to austerity measures implemented by the left-wing government of Alexis Tsipras, Greece's inefficient economy has been improved and today is in an incomparably better condition and will be able to cope more easily with the coming crisis. Following the neo-classical policy-making approach, implementing austerity measures in the public sector, and large-scale privatization projects, Tsipras reduced public debt and stabilized the national economy. The gross domestic product started again to grow in 2017 by 1,5 and in 2018 by 1,8 percent.

Generally speaking, the crisis comes and goes. So will this. Schumpeterian would call such a situation as business cyclical ebbs and troughs; the Keynesians will see it as a deviation from the full-employment; the nee-liberalists see it as normal money and commodities market adjustment, and thus the policymaking responses will differ accordingly (Soumitra Sharma 2015). Only, what we will be faced with are the consequences – for some bitter for others sweet.

Croatian Economy – Between Two Economic Crises

Croatia has painfully recovered for more than six years from the 2008 crisis, largely due to the absence of anti-cyclical government measures. Instead of austerity measures (which in Greece

achieved *Keynesian effects*), Croatian governments have implemented *quasi-Keynesian* economics of increasing the tax burden and public spending. Public debt exploded from 39, 8 percent to GDP in 2008 to 84, 7 percent to GDP in 2014.

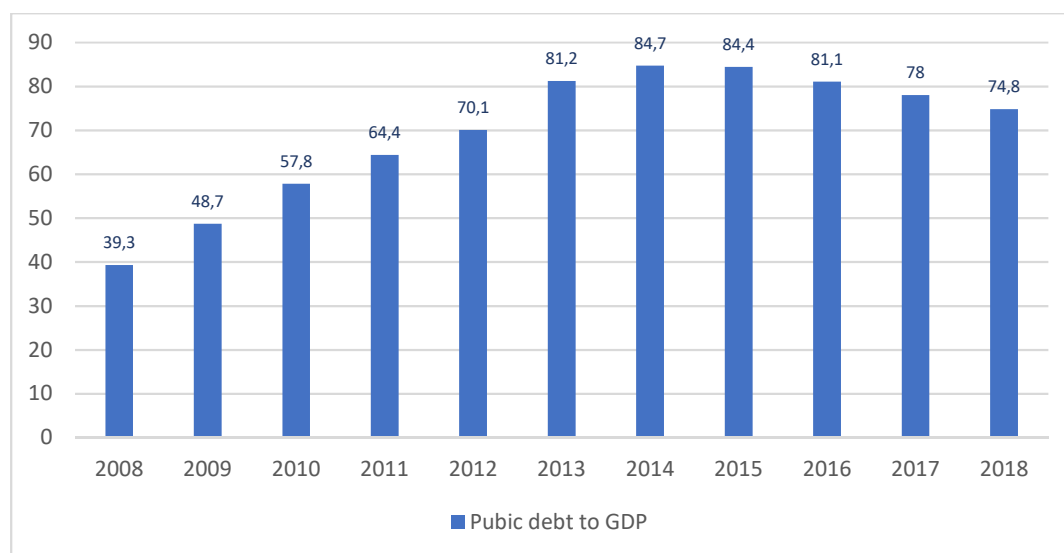


Table 1: Croatian Government debt to GDP 2008-2018; source: Croatian National Bank

Public debt started to decrease in 2015 as the result of EU accession and implementation of the Macroeconomic Imbalances Procedure. The first surpluses in the public sector were created only in 2018 and were soon spent on the payments of government guarantees issued to the troubled shipbuilding industry.

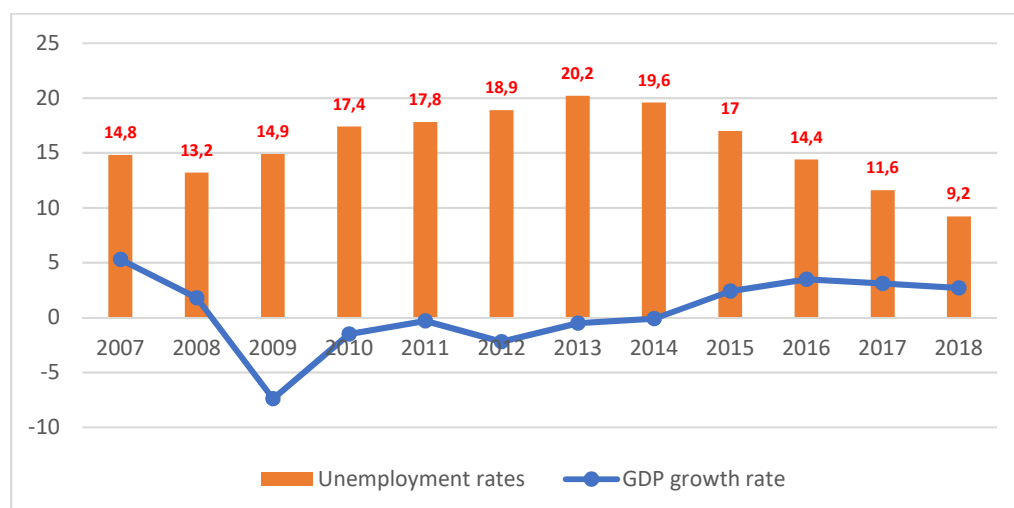


Table 2: GDP growth rates and unemployment rates 2007 -2018; source: Croatian National Bank

An increase in public spending did not result in short term economic recovery. On the contrary, economic output dropped by 7, 4 percent in 2009; the unemployment rate increased from 13, 2

percent in 2008 up to 20, 2 in 2013. Croatian economy started to grow in 2015, after EU accession.

Increasing economic output in the recent couple of years, mostly coming from the booming touristic sector and successful real convergence of domestic export-oriented small and medium enterprises encouraged the Croatian Government to further increase public spending in 2018 after the public finance consolidation program has been implemented within Macroeconomic Imbalances Procedure between 2014-2017.

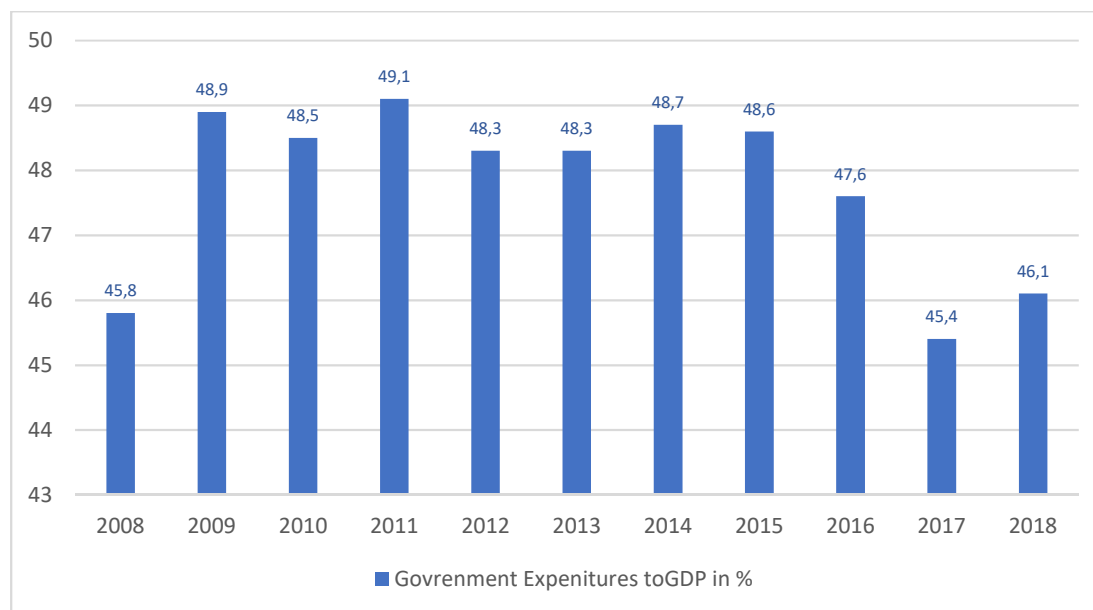


Table 3: Pubic expenditures 2008- 2018; source: Croatian National Bank

The upcoming economic crisis will hit the Croatian economy strongly. The government recently announced that the domestic economy will drop down by 9, 4% in 2020, following estimates of IMF and other international institutions. However, coronavirus caused lock-down and negative expectations in the touristic sector, which contributes directly and indirectly to GDP creation with 20 percent, which could influence economic activities much stronger than expected.

The Croatian government has not sufficiently fiscal capacity for stronger intervention, such recently conducted by the Croatian National Bank to stop speculation in the foreign exchange market and ensure liquidity in the financial sector. Unlike the central bank, which in the meantime has created high foreign exchange and monetary reserves, the government sector has steadily increased its spending faster on the GDP growth. Therefore, the Croatian business sector should not expect stronger government intervention and rain of financial injections. Unless the Government will decide on a new, cycle of borrowing and thus jeopardize its entry into the European Monetary Union.

How to Find the Way Out of the Crisis

Today, while some economic scientist sees the recession as a short-run phenomenon and normal behavior of the market economy others are alarmed and cry for hurried macroeconomic solutions and strong policy responses. Lesson learned from the Great Crisis in 2009 is showing us that monetary intervention and an increase in money supply is more than welcome to assure liquidity. Traditionally conservative central bankers are surprisingly reacting to the recession with unorthodox instruments and measures supplying the economy with enough money, from FED to BoE and ECB. Including Croatian National bank, which already supplied the financial sector with money. I hope that will the liquidity reach the businesses, which desperately need it? However, financial institutions are not in the crisis increasing their risk appetite, but rather willing not to borrow to the businesses. Therefore, would be needed strong fiscal injection into the business sector to assure liquidity and increase the bankability of small and medium enterprises and to save the jobs. Fiscal intervention should affect both, the supply and the demand side. Since the contraction will be sharp, a fiscal intervention must be very strong if policymakers would like to see the "V" shape recession. If the injection from the public sector to the business sector will not enough robust, the recession could turn into stagnation. That is the problem with Keynesian economics. Therefore, there is a lot of evidence suggesting that policymaking response to the coming recession, while we are faced with drop down in demand and lack of supply because of anti- coronavirus measures, should be the composition of fiscal measures affecting aggregate supply and demand and classical austerity measures in the public sector to order to assure fiscal intervention capacity and not to increase the public debt.

The Croatian economy is highly dependent on tourism. However, the integration of small and medium companies into supply chains of the European manufacturing industry increased after EU accession. As soon as the recovery starts in Germany and other western European markets in which are domestic SMEs well integrated, the output of this sector will increase its share in GDP creation. Therefore, is government intervention in the sector extremely important. European structural and cohesion funds are today available which will co-finance public and private investments. Important will be that the Government allocates ESI funds to encourage local community projects and investments in the manufacturing industry in rural areas where primary sector output is available as locally available input for wood- and food processing companies. The banking sector is well capitalized and stable. Croatian National Bank could increase money supply relaxing regulatory and macro-prudential framework. Thus, the macro- and microeconomic environment in the Croatian economy is much more promising concerning the short-term recovery compared to the recession in 2009.

Still, the major challenge is an adjustment of the Croatian public sector, which including state-owned enterprises contributes to the GDP and jobs creation up to 40 percent. The public sector

is highly inefficient; it is indebted and not ready to adjust. Along with the worst economic downturn we have seen in the past decades, the government deficit will increase by 5, 0 billion euros at least this year, reaching 85 – 90% percent to GDP. Austerity measures should be the policy-making response. Nevertheless, strong public-sector unions are strongly opposing public spending reduction, including a decrease in wages and salaries and structural reforms on the expenditure side.

Some further recommendations

Croatia is a small economy with significant economic potential. Appropriate government policies could prevent the complete erosion of the national economy, trigger recovery, and accelerate economic growth. Moreover, the crisis caused by the spread of coronaviruses could be appropriate timing to implement structural reforms advocated by the enterprise sector for years.

The intervention of the Croatian government should have the strength at least five billions of euros and be targeted at retaining jobs and improving households' and businesses' balance sheet in the short term. Some recommendation coming from "10-Punkte Survival-Guide für den Shutdown" - <https://www.freiheit.org/jetztmutmachen-10-punkte-survival-guide-fur-den-shutdown> - recently published by Friedrich-Naumann-Foundation for Freedom, could be implemented by the Croatian policymakers:

- i. easy access to the financial instruments adjusted for and suitable to the small and medium enterprises backed with government warranties;
- ii. corporate tax relief in 2020; and
- iii. new-start incentives program as positive sign to the employees and SMEs

Coronavirus pandemic? We will have to learn to live with this health threat and hopefully have scientific answers soon. The day after in the Croatian economy could lead to the new economic cycle with robust economic growth, but also could lead to the midterm stagnation, another decade lost for the socio-economic development. It is depending on the policymaking response to the crisis.

